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The New Renminbi Offshore Scheme: China's First Step Towards Liberalizing the RMB into an International Reserve Currency

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1. INTRODUCTION

If a country's national currency is also an international reserve currency, this can present certain advantages. For example, the rise of the US Dollar (the "USD") as the international reserve currency in the 20th Century allowed the United States (the "US") to reinforce its dominance over the world economy during the period by holding much of the world's gold reserves. The US can exert strong influence on monetary policies in other countries through the Federal Reserve System (the "Fed") because of their need for and holdings of dollars, as well as through the International Monetary Fund (the "IMF"), as the latter's largest shareholder. During the East Asian Financial Crisis in 1997, the IMF policies, which encouraged full capital account liberalization and the adoption of the "Washington Consensus"[1], created soaring unemployment rates and social instability in emerging markets in East Asia[2]. In that context of that crisis, the government of the People's Republic of China ("China") successfully protected its economy from this currency crisis in 1997 by devaluing the RMB and maintaining its capital account controls.[3] At the same time, China holds a sizeable foreign exchange reserve, which reached USD 2.64 trillion by the end of 2010 and maintained a trade surplus with the US.[4] China's unprecedented growth rates and the significant appreciation of the RMB during recent years has set out the preconditions to develop the RMB into becoming an alternate international reserve currency.

The launch of the RMB trade-settlement scheme in July 2009[5] (the "Pilot Scheme") and its expansion in July 2010 encourages traders outside of China to use the RMB as a medium of exchange, which is important for the RMB to become an international reserve currency. This formed the backbone of the RMB offshore centre in the Hong Kong Special Administrative Region ("Hong Kong"), where many RMB-denominated bonds are being offered to the public and receives a large portion of China's overseas direct investments ("ODI") in RMB. As the RMB is more frequently used as a settlement currency, the confidence in the RMB would increase so that one day it will be able to take on the role of an international reserve currency. This paper will examine the offshore RMB system and how it

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1 A standard reform package comprising of macroeconomic stabilization policies that are promoted for developing countries suffering from financial crises by the IMF and US Treasury Department.

2 Hubbard, Glenn R., *Money, The Financial System, and the Economy (6th Edition)*, Pearson International Edition 2008, 210

3 Furguson, Niall, *The Ascent of Money: A Financial History of the World,* Penguin Books 2009, 334

4 Yam, Joseph, *'The International Monetary System and the Renminbi'*, speech given at the China Investment Summit Bank of America Merrill Lynch, 3 November 2010, 5

5 Measures for Pilot Management of RMB Settlement for Cross-border Trade, July 1 2009

integrates with China's onshore RMB system and its impact on cross-border trade transactions between China and abroad.

This paper is organized as follows. Part 2 will discuss the background to the development of the Pilot Scheme. Part 3 will discuss the structure of the foreign exchange system in China. Part 4 will discuss the structure of the Pilot Scheme and an assessment of the Pilot Scheme will be discussed in Part 5. Given the rapid expansion of the offshore RMB money market, this paper will ultimately predict the next steps of the development of the offshore RMB system in the near future.

2. BACKGROUND TO THE DEVELOPMENT OF THE RMB CROSS BORDER TRADE SETTLEMENT SCHEME

2.1 The Evolution of the US Dollar as the international reserve currency

Mundell's theory of superpower influence suggests that 'when a country is a super-economy, its currency often fulfills many of the functions of an international currency'[6]. The US is at present a 'super-economy' and plays a central role in the International Monetary System. Prior to the rise of the USD, gold was used as the single international reserve currency[7]. This was also known as the gold standard, which was made credible under the strength of the British economy at that time. Britain then became a superpower by holding a large amount of such gold reserves and was receiving significant trade surpluses.[8] During the period of bimetallism in 1815 to 1873, the USD had a fixed exchange rate against a gold standard.[9] In other words, the US governments determined the agreed amount of gold that is equivalent to the currencies of participating countries. Yet, this international trading system collapsed during World War I and many countries had stopped converting their currencies into gold to prevent the risks of deflation.[10]

Subsequently, the US had gained dominance in the world economy through holding much of the world's gold reserves. The establishment of the Bretton Woods System allowed the US to dictate the fixed exchange rate of the USD to gold at USD 35 per ounce in 1945.[11] Hence, the USD naturally played an important role in the world financial structure as the currency of a superpower. Furthermore, the IMF also played an important role in helping the US gain dominance. It was established at Bretton Woods in 1944 to prevent the 'short-term economic dislocations that threatened the stability of the gold standard' by acting as the lender of last resort.[12] It also regulated member countries by encouraging domestic economic policies that promote exchange rate stability. However, the expansion of the role of the IMF over the years has led to much controversy where the US was seen to abuse its superpower by

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6 Mundell, Robert A., 'The International Monetary System in the 21st Century: Could Gold Make a Comeback?', Columbia University, March 12 1997, 4

7 Ibid, 4

8 Hubbard, Glenn R., *Money, The Financial System, and the Economy (6th Edition),* Pearson International Edition 2008, 517

9 Mundell, Robert A., 'The International Monetary System in the 21st Century: Could Gold Make a Comeback?', Columbia University, March 12 1997, 6

10 Hubbard, Glenn R., *Money, The Financial System, and the Economy (6th Edition),* Pearson International Edition 2008, 517

11 Ibid, 517

12 Ibid, 517

imposing monetary policies on other countries for its own benefit. This was evident in the East Asian Financial Crisis in 1997, which will be discussed later.

The Bretton Woods System had collapsed in 1971 as foreign central banks had accumulated more than three times the official gold holdings in the US.[13] President Nixon attempted to force other currencies to revaluate against the USD, by imposing a supplementary tariff on imports on countries that did not revaluate its currency. In the end, the US suspended the convertibility of USD into gold[14] and a flexible exchange rate of the dollar was introduced to the world economy in which the market determines the foreign-exchange value of the USD.[15] The intervention of the Federal Reserve System and foreign central banks in managing the fluctuations of the domestic currency is evident and the current international financial system is described as a ‘managed float regime’.[16] This regime was also adopted by China recently, where the volatility of the RMB is managed against the USD, and will be discussed later. Consequently, the USD has now evolved into a medium for conducting international trade and financial transactions giving the US political and economic supremacy under the support of the IMF[17]. Nonetheless, gold is still considered to be an important commodity held on reserve in the International Monetary System after the USD[18] and the price of gold is now determined by the supply and demand in the market.

[13] Hubbard, Glenn R., *Money, The Financial System, and the Economy (6th Edition)*, Pearson International Edition 2008, 523
[14] Ibid, 523
[15] Hubbard, Glenn R., *Money, The Financial System, and the Economy (6th Edition)*, Pearson International Edition 2008, 524
[16] Ibid, 524
[17] Mundell, Robert A., ‘The International Monetary System in the 21st Century: Could Gold Make a Comeback?’, Columbia University, March 12 1997, 4
[18] Ibid, 1

2.2 The Federal Reserve System

The success of the modern US banking industry was largely under the influence of the Fed that was established by Congress in 1913 and serves as the 'bank of last resort' during banking crises.[19] The Fed lends funds to banks that encounter bank runs and collapses of commercial credit by issuing discount loans that are based on its resources including gold, member bank reserves, and the statement of 'full faith and credit of the US government.'[20] The success of this regulatory response was recently demonstrated after the 9/11 terrorists attacks in New York and the Pentagon, by responding instantly to boost the economy.[21] Therefore, the Fed has gained the status of a credible lender of last resort and is one of the major regulators of the banking industry in the US.

At the same time, the Fed became a monopoly in issuing currency, which was previously the function of the US Treasury Department.[22] Thus, the Fed is now accountable for managing the money supply in the US. This in turn affects interest rates, exchange rates, inflation and an economy's output of goods and services.[23] In fact, the Fed has intervened three times by November 1998 to expand the money supply in the US, causing the US stock market to rise and stimulating consumer spending with the lowered interest rates.[24] Recently, Professor Chan said "the second round of quantitative easing in the US has caused low interest-rates and a capital overflow, inviting more speculative activities in the world" and advised investors to be vigilant, as the low-interest rate environment will change any time.[25] In effect, the Fed can determine the level of liquidity in the financial market with its ability to change the monetary base[26] (all the currency in circulation and the reserves held by banks).

In addition, Mundell stated that the Fed was 'the greatest engine of inflation ever created'[27]. Under the Keynesian model, this is achieved by holding interest rates low, resulting in excessive aggregate demand and hence inflation. Conversely, Austrian models

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[19] Hubbard, Glenn R., *Money, The Financial System, and the Economy (6th Edition)*, Pearson International Edition 2008, 315

[20] Ibid, 316

[21] Ibid, 342

[22] Ibid, 314

[23] When interest rates are low, consumers and businesses will spend more causing economic growth and increasing inflation pressures.

[24] Hubbard, Glenn R., *Money, The Financial System, and the Economy (6th Edition)*, Pearson International Edition 2008, 386

[25] *'Pilot Scheme to boost RMB growth', http://www.* news.gov.hk January 15 2011 (online version)

[26] *Liquidity and the Monetary Base,* Bloomberg News, November 24 2006

[27] Mundell, Robert A., 'The International Monetary System in the 21st Century: Could Gold Make a Comeback?', Columbia University, March 12 1997, 5

suggest that the low interest rates encourage excess borrowing, which causes an imbalance between saving and investment.[28] This was the case in the US before the financial crisis, which gave rise to asset bubbles and consumer-price inflation. Despite this, inflation has its perks as it brings full employment of the economy's resources and this is the reason why governments pursue inflationary monetary policies.[29] In essence, the Fed is an important institution that regulates the foreign-exchange value of the USD, which in turn protects the nation from future financial crises.

China is currently experiencing an unprecedented growth rate and the direction it has followed is unique to the development of the US economy and rise of the USD as an international reserve currency. Whether China can provide an alternative reserve currency depends on whether China will adopt similar methods, such as the establishment of the Fed, to promote monetary stability. However, it seems that once again China has its own ways of doing so when it survived the East Asian Financial Crisis in 1997, which will be discussed in the next section. It is clear that the Chinese government and the central bank play a big role in developing the nation's economy into the world's second largest economy, which is still growing to surpass US dominance one day.

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[28] *The Weeds of Destruction*, The Economist, May 6 2006

[29] Hubbard, Glenn R., *Money, The Financial System, and the Economy (6th Edition)*, Pearson International Edition 2008, 666

2.3 The East Asian Financial Crisis

The East Asian Financial Crisis in 1997 was a clear case of market failure, when free markets became markets that were freely manipulated by the US as a superpower[30]. This illustrates that US dominance in the world economy is undesirable. The crisis was initiated when the World Bank, a financial institution also established at Bretton Woods in 1944, made long-term loans to developing countries such as Thailand, Malaysia, Korea, the Philippines and Indonesia for the purpose of funding the construction of infrastructure to stimulate economic development.[31] This led to the world debt crises in the 1980s**,** when the IMF stepped in to provide credit to these developing countries to help them repay their loans with the World Bank.[32] Stiglitz claimed that the IMF policies were pursued in the interest of the creditors, where much of the taxpayers and workers in those countries had the burden to pay off the IMF loans to American and European creditors.[33] Critics have also observed that confidence in a currency can quickly breakdown when short-sighted macroeconomic policies are pursued.[34] In the end, the IMF's 'beggar-thyself' policies[35] had adversely affected almost every emerging market in East Asia.

Moreover, Stiglitz believed that full capital account liberalization that was imposed by the IMF and the US Treasury was the most important factor leading to the financial crisis as it attracted a lot of 'hot money' into the country.[36] In the case of Thailand, speculators bought a large amount of USD with the Thai Baht, resulting in a weakened value of the Baht. Consequently, the exchange rate fell and the speculators then moved back into the currency and made a substantial profit.[37] At the same time, the government tried to buy up the local currency to sustain the exchange rate until eventually the nation's reserves were depleted and the currency crashed.[38] In effect, short-term speculative money that came in and out of the country created financial instability instead of real economic growth during the crisis.[39] Out of all the countries affected by this IMF policy, only Malaysia was able to lessen the

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[30] Yam, Joseph, *'Lessons Learnt from Financial Crises – A Central Banker's Perspective'*, speech given at the Ninth Annual Asia Pacific Summit Morgan Stanley on 10 November 2010, 2

[31] Hubbard, Glenn R., *Money, The Financial System, and the Economy (6th Edition)*, Pearson International Edition 2008, 518

[32] Stiglitz, Joseph, *Globalization and its Discontents*, Penguin Books 2002, 99

[33] Ibid, 209

[34] Yam, Joseph, *'Role of China in International Finance'*, speech given at The Annual Financial Markets Dinner of Scotia Capital, Toronto, Canada, 15 September 2010

[35] Stiglitz, Joseph, *Globalization and its Discontents*, Penguin Books 2002, 106

[36] Ibid, 93

[37] Ibid, 95

[38] Ibid, 95

[39] Yam, Joseph, 'A Safe Approach to Convertibility of the Renminbi', April 6 2011, 3

detrimental impact of the 'hot money' into the country by halting its rapid outflow, while keeping interest rates low.[40] Until today, the IMF's role in determining capital account convertibility remains unknown.[41]

Also, countries involved in the crisis were recommended to follow the "Washington Consensus", which was modeled to assure them of growth and macrostability.[42] This policy emphasized trade and promoted exports and aimed to create jobs in the export industries. It also encouraged privatization, which in turn urged for a minimalist role for the government.[43] However, the IMF did not take into account that it was in fact the government policies and interventions that led to the successful development of East Asian countries like in the case of China, which will be discussed later. Moreover, Joseph Yam observed that Government intervention gave rise to a better track record of the maintenance of financial stability than in capitalist jurisdictions with a free market model.[44] Therefore, the "Washington Consensus" turned out to be very dangerous for developing countries and was a complete failure. Consequently, such 'austerity' programs led to unemployment, political risk and social instability[45] and the unemployment rate went up fourfold in Korea, threefold in Thailand, tenfold in Indonesia.[46]

The detrimental effects created by the IMF policies in this crisis suggest that US dominance many not be advantageous to other developing countries in the world. This is one reason why China wants to step in to eliminate the abuse of power by the US and the first step is to internationalize the RMB. Of course, the battle towards being a superpower would undoubtedly create political tension between the two countries, where China is taking a gradual approach towards liberalization of the RMB through a slowed appreciation of its currency.

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[40] Stiglitz, Joseph, *Globalization and its Discontents*, Penguin Books 2002, 93

[41] Yam, Joseph, 'A Safe Approach to Convertibility of the Renminbi', April 6 2011, 3

[42] Ibid, 213

[43] Ibid, 92

[44] Yam, Joseph, *'Lessons Learnt from Financial Crises – A Central Banker's Perspective'*, speech given at Ninth Annual Asia Pacific Summit Morgan Stanley, 10 November 2010, 4

[45] Hubbard, Glenn R., *Money, The Financial System, and the Economy (6th Edition)*, Pearson International Edition 2008, 210

[46] Stiglitz, Joseph, *Globalization and its Discontents*, Penguin Books 2002, 97

2.4 The undervalued RMB – a problem for the US?

A nation's currency will develop into an international reserve currency as its value increases. This creates confidence for the market to use this as a medium of trade. However, China has been trying to keep the RMB value low through various stages to maintain its monetary stability. For example, the Chinese Government's involvement in devaluing the RMB in 1994 and maintaining its capital account control allowed China to survive the currency crisis in 1997.[47] Also, China's Central Bank, the People's Bank of China (the "PBOC"), bought billions of dollars of US Treasury Bonds to prevent the appreciation of the RMB.[48] By the end of 2010, China has accumulated a substantial amount of foreign exchange reserves coming close to $2.64 trillion[49]. Interestingly, this net increase almost corresponded to the net issuance of US Treasury Bonds and as a result China had become the banker of the US.[50] Overall, the RMB appreciated 26% since 2006, but this figure diminishes to 6% appreciation against the trade weighted scale taking into account the concurrently depreciating USD.[51] On June 19 2010, the PBOC enhanced the RMB exchange rate flexibility and allowed the RMB to appreciate considerably against the USD. By December 2010, the RMB/USD exchange rate rose about 2.9% overall.[52] Today the average exchange rate as quoted by HSBC is 6.39 RMB to the USD[53]. The slowed appreciation enabled Chinese corporations to adjust more easily to the fluctuations of the RMB,[54] while still pushing the RMB to become an international reserve currency.

Among the world's emerging markets, China has received the most foreign direct investments upon the transition from a central planning economy to a market economy[55] and when the USD peg against a basket of currencies was established in 1994. This consisted largely of US Corporations who out-source their manufacturing to China and subsequently benefit from the cheap labour and Chinese imports also kept down US inflation.[56] On the other hand, Chinese workers benefit from the increased employment and a better standard of

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47 Furguson, Niall, *The Ascent of Money: A Financial History of the World*, Penguin Books 2009, 334

48 Ibid, 335

49 Yam, Joseph, *'The International Monetary System and the Renminbi'*, speech given at the China Investment Summit Bank of America Merrill Lynch, 3 November 2010, 5

50 Furguson, Niall, *The Ascent of Money: A Financial History of the World*, Penguin Books 2009, 335

51 Meier, Andre, IMF Representative and Speaker at 'The Renminbi's Changing Status and the Chinese and Hong Kong Financial Systems', CFRED Conference at CUHK, 11 August 2011

52 Cheung, Zhi Keung, Lui Yu, *Huobi Zhanzhengzhong De Renminbi*, Economics Daily Publishing 2011, *9*

53 Bank of China, 14 August 2011

54 Morrison, Wayne M. and Labonte, Marc, *China's Currency: A Summary of the Economic Issues*, RS21625, Congressional Research Service Report for Congress Apr.13 2009, 4

55 Stiglitz, Joseph, *Globalization and its Discontents*, Penguin Books 2002, 183

56 Furguson, Niall, *The Ascent of Money: A Financial History of the World*, Penguin Books 2009, 335

living and social stability.[57] This phenomenon of globalization has tied China and America together into what Furguson calls 'Chimerica'.[58] Therefore, it is important for China to keep its RMB undervalued to keep its immense population employed through exporting manufactures to the 'insatiably spendthrift US consumer'.[59] However, it has been suggested that such an "investment boom" is not sustainable and more has to be done to promote monetary stability of the RMB.[60]

Conversely, it was suggested that China is undervaluing its currency to obtain an 'unfair trade advantage' because the relatively cheaper RMB compared to the USD would stimulate Chinese exports to the US whilst suppressing the opposite flow.[61] In 2008, the US trade deficit with China amounted to USD 266 billion[62] and there was a loss of 2.4 million industrial jobs in the US between 2001 and 2008.[63] This has created political tension between the two countries because the trade deficit creates an increased reliance on China to make loans to the US year after year, which in turn gives China more leverage on providing capital to the US.[64] This is certainly an obstacle China has to overcome in order to reach its goal of internationalizing the RMB. Therefore, the revaluation of the RMB is predicted to help re-balance the trade relationship between China and the US, and restore employment in the manufacturing sector in the US. Changes to the macroeconomic practices where the US will have to consume less and save more, while China will have to consume more and save less, would make the revaluations even more effective.[65] Additionally, critics stated that the RMB should be allowed to float freely and appreciate according to the supply and demand in the Chinese and American economies [66] in order to ease the trade deficit pressures. These are possible solutions to lessen the US' trade deficits with China, and potentially ease the political tension.

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57 Stiglitz, Joseph, *Globalization and its Discontents*, Penguin Books 2002, *92*

58 Furguson, Niall, *The Ascent of Money: A Financial History of the World*, Penguin Books 2009, 336

59 Ibid, 335

60 Meier, Andre, IMF Representative and Speaker at 'The Renminbi's Changing Status and the Chinese and Hong Kong Financial Systems', CFRED Conference at CUHK, 11 August 2011

61 Bhala, Raj, *Virtues, the Chinese Yuan, and the American Trade Empire*, 38 HKLJ 183, 4

62 Morrison, Wayne M. and Labonte, Marc, *China's Currency: A Summary of the Economic Issues*, RS21625, Congressional Research Service Report for Congress Apr.13 2009 - Summary

63 *Unfair China Trade Costs Local Jobs 2.4 Million Jobs Lost, Thousands Displaced in Every US Congressional District*, Economic Policy Institute, Briefing Paper #260

64 Stiglitz, Joseph, *Globalization and its Discontents*, Penguin Books 2002, 200

65 Morrison, Wayne M. and Labonte, Marc, *China's Currency: A Summary of the Economic Issues*, RS21625, Congressional Research Service Report for Congress Apr.13 2009, 1

66 Bhala, Raj, *Virtues, the Chinese Yuan, and the American Trade Empire*, 38 HKLJ 183, 4

During the East Asian Economic Crisis, China has managed its growth with a tightened foreign exchange policy to protect its currency from being 'attacked' by international currency speculators.[67] Up to today, foreign exchange in relation to capital account transactions is still subject to approval, while foreign exchange flow from current account transactions is permissible but subject to a monitoring system that requires documentary support[68]. However, Chinese traders, investors and financial institutions are still subject to a significant foreign exchange risk as they continue to rely on the USD[69]. Therefore, China has naturally taken steps to promote a wider use of RMB outside China, in cross-border trade and investment, while moving away from the previously closed system.

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[67] Zee Winston K., *China Forex Handbook* Hong Kong, Asia Information Associates Ltd 1999, 2

[68] Mercurio, Bryan, Leung, Celine Sze Ning, *Is China a "Currency Manipulator"? The Legitimacy of China's Exchange Regime under the Current International Legal Framework,* 43 Int'l Law 1257

[69] Yue, Eddie, *Hong Kong as an International Financial Centre: The China Factor,* speech given at "Hong Kong: China's Global Financial Centre" Conference New York, March 1 2011

2.5 China's Objectives

In the past three decades, the Chinese economy has undergone extraordinary growth, so much that it became the world's second largest economy, overtaking Japan and Germany in the process. One of its long-term goals is to provide an alternative international reserve currency to the depreciating USD in the global economy. In fact, the more widespread use of alternative reserve assets is encouraged by the IMF Managing Director in order to "provide a safety valve from unsound policies of any single reserve issuer"[70]. To realize its goals, China has taken the first step and has started to send RMB offshore under the Pilot Scheme promulgated by the PBOC in July 2009[71]. Subsequently, the Pilot Scheme was expanded to cover more enterprises and participants in July 2010[72] and ODI in January 2011[73]. At the same time, Hong Kong has become the first offshore settlement centre to clear and settle cross-border trades in RMB outside of China.[74] With so much pressure for the RMB to appreciate, China has been rethinking its position in the world economy as a nation with a major trade surplus with the US and holds the most foreign reserves in the world. Therefore, China is trying to change the rules of the game and encouraging greater use of the RMB as a settlement currency.

According to Joseph Yam[75], there are certain characteristics China has to achieve in order for the RMB to reach its long-term goal. First of all, there must be a sizeable and healthy economy to back up the currency[76], which is evident at the pace of China's growth. Also, the RMB must be a medium of exchange and a store of value[77]. This is currently taking place under the Pilot Scheme today, where goods are settled in RMB and many retail shops in Hong Kong accept payments in RMB.[78] Of course, liquidity must be fluid in the market in order for banks and market participants to avoid liquidity and credit risks. There must also be

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[70] Yam, Joseph, *'The International Monetary System and the Renminbi'*, speech given at the China Investment Summit Bank of America Merrill Lynch, 3 November 2010, 6

[71] Measures for Pilot Management of RMB Settlement for Cross-border Trade, July 1 2009

[72] PBOC Circular [2010] 186

[73] Administrative Measures for the Pilot RMB Settlement of Overseas Direct Investment, No.1 [2011], January 6 2011

[74] Ho, Candy C.Y., *Renminbi Cross-Border Payment Arrangement*, 25 Banking and Finance Law Review 435 June 2010, 1

[75] Yam, Joseph, *'The International Monetary System and the Renminbi'*, speech given at the China Investment Summit Bank of America Merrill Lynch, 3 November 2010, 5

[76] Ibid 5

[77] Ibid 5

[78] *'Dim Sum' Development: Hong Kong Spurs an Offshore Renminbi Boom,* Knowledge Wharton University of Pennsylvania (online version) http://www.knowlegeatwharton.com.cn/index.cfm?fa=viewArticle&articleID=2357

an international market confidence in China's currency,[79]supported by a robust capital market in the currency such as bond trading, hedge funds and Initial Public Offerings ("IPOs"). Currently, there is an increasing variety of RMB bonds in the market, nicknamed 'dim sum bonds' by traders, and RMB finance such as loans are also available to market participants. We will discuss later what China is doing to create assurance and confidence in the RMB to the general public. In other words, China's domestic economy must be strong enough to withstand the shocks in the financial and commodity markets. Last but not least, China must achieve full capital account convertibility in order to realize its goal.

It is predicted that the RMB can achieve the status of an international reserve currency within the next 20 years, as it will take some time to achieve capital account convertibility.[80] The Hong Kong Exchange Chief Executive, Charles Li, said that China will be able to achieve its goal as long as it is implemented with caution and gradually, controlled and through pilot experiment and being offshore.[81] When this happens, it is possible for the RMB to become the legal tender of Hong Kong under the constitutional basis of the RMB because Hong Kong is an inalienable part of the PRC (Article 1, Basic Law of HKSAR).[82] At the same time, the Pilot Scheme is expected to benefit the development of Hong Kong as an international finance center[83]-a major component of *HKEx's 2010-2012 Strategic Plan*[84]. Financial analysts predict that China could overtake the US in terms of per capita GDP by 2027, with the phenomenal growth of 8.4% in the past 30 years.[85] Therefore, the more moves China makes towards this long-term goal, the more influence China will have in the geopolitical arena.

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[79] Yam, Joseph, *'The International Monetary System and the Renminbi'*, speech given at the China Investment Summit Bank of America Merrill Lynch, 3 November 2010, 5
[80] Ibid 5
[81] Ibid 5
[82] Hoo, Alan, Chair of the Basic Law Institute and Speaker at 'The Renminbi's Changing Status and the Chinese and Hong Kong Financial Systems', CFRED Conference at CUHK, 13 August 2011
[83] Yam, Joseph, *'The International Monetary System and the Renminbi'*, speech given at the China Investment Summit Bank of America Merrill Lynch, 3 November 2010, 5
[84] HKEx Strategic Plan 2010-2012, Hong Kong Exchanges and Clearing Ltd.
[85] Furguson, Niall, *The Ascent of Money: A Financial History of the World*, Penguin Books 2009, 285

3. THE STRUCTURE OF THE FOREIGN EXCHANGE SYSTEM IN CHINA

3.1 China's Foreign Exchange Policies

China's GDP has registered a remarkable 29-fold increase over the past three decades, from around USD 200 billion to more than USD 5.8 trillion in 2010, with an average annual growth of 10%.[86] Undoubtedly, the successful transition from a central planning economy to a socialist market economy in 1978 and the liberalization of the current account in 1996 contributed significantly to this phenomenal growth, and China has managed such growth with a tightly controlled foreign exchange policy. Since 1993, multinational enterprises doing business with China can only settle their cross-border trade transactions in a foreign currency[87], mostly in USD because it still remains as the international settlement currency. But the recent launch of the Pilot Scheme in September 2009 and its expansion in July 2010 marked a significant change to the foreign exchange system, intending to act as a further stimulus to China's growth and to promote more widespread use of the RMB.

The complicated procedures involved in the payment remittance under cross-border transactions have contributed to significant administrative costs and delays when foreign entities operate and do business in China. Generally, when a transaction with China is carried out it is classified into a current or capital account transaction. A current account transaction refers to normal day-to-day operational transactions in the ordinary course of business and involves international receipts and payments including trade, service and other transactions such as payment of royalties, rent and dividends etc.[88] More importantly, foreign exchange flows under the current account has achieved full convertibility but subject to a monitoring system requiring documentary support. However, these administrative burdens are not significant enough to impede China's tremendous trade volume with the US and other neighbouring countries. In other words, so long as the RMB remains undervalued and traders are still willing to trade with China under the current foreign exchange system.

[86] Yue, Eddie, *Hong Kong as an International Financial Centre: The China Factor,* speech given at "Hong Kong: China's Global Financial Centre" Conference New York, March 1 2011

[87] Announcement of the People's Bank of China Concerning Further Reform of the Foreign Exchange Control System, December 28 1993; Regulations of the People's Republic of China for the Control of Foreign Exchange, January 8 1996

[88] Zee Winston K., *China Forex Handbook* Hong Kong, Asia Information Associates Ltd 1999, 13

On the other hand, a cross-border capital account transaction refers to direct investment and loans and securities investment, including repayment of principles of foreign debt and remittance of capital by Foreign Investment Enterprises ("FIEs") [89] after liquidation.[90] Under the *Administrative Rules of the People's Republic of China on Foreign Exchange Control (2008 Rules)* [91], capital account transactions require approval from supervising authorities including the Ministry of Commerce (the "MOFCOM") and the State Administration of Foreign Exchange (the "SAFE")[92]. On a higher level, the PBOC at the ministry-level overlooks the SAFE, which is under the State Council.[93] Therefore, foreign exchange remitted into China under a capital account transaction is subject to stringent approval and controls. Up to today, China has not achieved full capital account convertibility.

We now examine the detailed procedures of the current account transactions settled in foreign exchange, including export and import of goods and service transactions to demonstrate the tedious and administratively burdensome processes.

[89] FIE's consist of Wholly foreign-owned enterprises (WFOE), Chinese-foreign Equity Joint Ventures and Chinese-foreign co-operative Joint Ventures

[90] Zee Winston K., *China Forex Handbook* Hong Kong, Asia Information Associates Ltd 1999, 21

[91] The 2008 Rules were promulgated as the No.193 order of the State Council of the PRC on Jan 29, 1996, and were amended according to the Decision of the State Council on Amending the Foreign Exchange Control Regulations of the PRC on Jan 14,1997. They were re-amended and passed in the 20th executive meeting of the State Council on Aug 1, 2008

[92] Arts 33-37, 2008 Rules

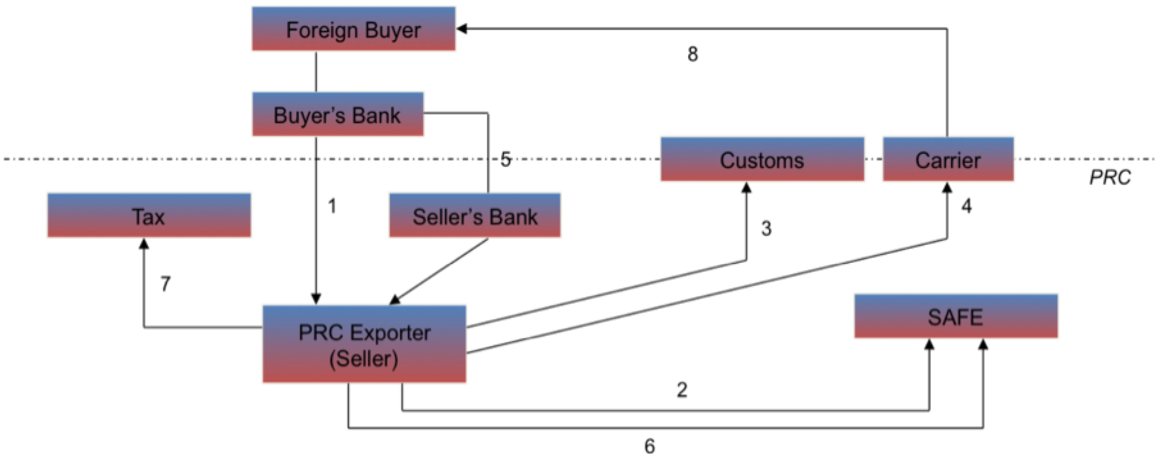
[93] Zee Winston K., *China Forex Handbook* Hong Kong, Asia Information Associates Ltd 1999, 4

3.2 Current Account Transactions settled in a Foreign Currency

3.2.1 Inbound payment of export of goods in foreign exchange

When a PRC exporter carries out an export transaction, it needs to undergo the foreign exchange verification and examination process with SAFE[94], where a range of documentary evidence are provided to show that they are genuine export transactions, and that the PRC exporter has received the foreign exchange after the goods are exported. Although this process is tedious, much of China's foreign exchange reserves come from the inflow of foreign exchange when foreign enterprises buy Chinese goods.[95] Therefore, this system acts as a 'buffer to foreign exchange receipts that arrive at the designated foreign exchange banks'[96] and aims to reduce the risk of abuse of the free convertibility policy of current account transactions.[97]

The following outlines the current cross-border settlement system and the verification and examination process as it relates to export of goods from China against payment in foreign exchange[98].



[94] Detailed Implementing Rules for the Measures for Administration of the Verification of Foreign Exchange Received from Exports, August 1 1998
[95] Chan, Daniel, Interview at DLA Piper Hong Kong on 28 February 2011
[96] Zee Winston K., *China Forex Handbook* Hong Kong, Asia Information Associates Ltd 1999, 59
[97] Ibid 47
[98] Chan, Daniel, Interview at DLA Piper Hong Kong on 28 February 2011

1. The PRC Exporter ("the Seller") signs an export contract denominated in a foreign currency (e.g. HKD) with the Foreign Buyer ("the Buyer"). The Buyer's Bank supplies a Letter of Credit to the Seller.

2. The Seller obtains a blank Export Verification Form ("出口收汇核销单") from the local SAFE.

3. The Seller fills out the Export Verification Form with relevant details, and presents this form together with other documents such as the customs declaration form and the export contract to Customs.

4. Once Customs processes the documents in Step 3 above, the Seller consigns the goods to a carrier in exchange for a Bill of Lading. The Seller sends the Bill of Lading to the Buyer's bank, which then passes it on to the Buyer in exchange for the payment.

5. When the Buyer pays the Seller's bank in the PRC, the Seller's bank will verify that the proceeds correspond to the amount stated in the export documents (including information contained in the Export Verification Form). If everything is in order, the Seller's bank in the PRC would issue a Confirmation of Receipts of Export Proceeds to the Seller, who may keep the payment in foreign exchange or convert it into RMB at the Seller's discretion.

6. The Seller then will bring this Confirmation and the Export Verification Form back to SAFE to undertake verification and examination. If everything is in order, SAFE will then close the file on this particular Export Verification Form.

7. The Seller separately can approach the tax authorities for refund of Input VAT on the strength of its exports.

8. The Buyer provides the Bill of Lading to the carrier and takes delivery of the goods.

It should be noted that under current practice, if a large number of such export verification forms remain open (such that the verification and examination process has not been completed), SAFE has the discretion to suspend the issuance of any further Export Verification Form to the relevant exporter until some old forms are cleared and closed via the above examination and verification process (Step 5).[99] In July 2009, the PBOC promulgated a set of pilot measures to promote RMB settlement for cross-border trade instead of in foreign exchange. More importantly, the Pilot Scheme no longer involves the elaborate examination and verification process with SAFE.[100] This is because the transaction is no longer denominated in foreign exchange. Nonetheless, the receipt of payment in RMB has to be reported to SAFE in the end. The effectiveness of the Pilot Scheme will be discussed later in the paper.

[99] Chan, Daniel, Interview at DLA Piper Hong Kong on 28 February 2011

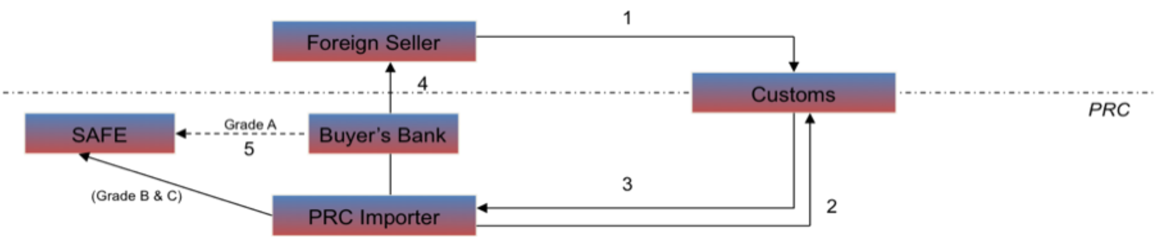
[100] Measures for Pilot Management of RMB Settlement for Cross-border Trade, July 1 2009

3.2.2 Outbound payment for import of goods in foreign exchange

Previously, this current account transaction was also subject to the verification and examination process similar to the exporting of goods, under *Provisional Measures for the Supervision of the Verification of Foreign Exchange Paid for Trade Imports*[101] promulgated by SAFE in 1997. The rationale behind safeguarding capital outflow is to minimize the effect of depleting China's foreign exchange reserve.[102] However by the end of 2010, China has accumulated USD 2.6 trillion worth of foreign exchange reserves[103]. Therefore, there are less concerns with capital outflow and since December 2010, PRC importers are no longer required to do the verification and examination process after the remittance stage, under Circular 57.[104]

Under the more relaxed system, PRC importers are classified into Grade A, B or C based on their performance and compliance status. These evaluations will be conducted by SAFE every six months and will be made available to the importers and banks. Grade A importers are those with good compliance track records with Customs, while Grade B and C importers have inferior compliance track records with Customs. Grade B and C importers must register each payment transaction with SAFE, but because Grade C importers are subject to the strictest control, they are not allowed to adopt collection and prepayment methods for settlement of outbound payment in foreign exchange. Therefore, there is much less interaction with SAFE for the importing procedures than exporting today.

The major procedures for settlement in foreign exchange in relation to import transactions undertaken by these types of importers are described below.



[101] Provisional Measures for the Supervision of the Verification of Foreign Exchange Paid for Trade Imports, March 1 1997

[102] Zee Winston K., *China Forex Handbook* Hong Kong, Asia Information Associates Ltd 1999, 59

[103] Yam, Joseph, *'The International Monetary System and the Renminbi'*, speech given at the China Investment Summit Bank of America Merrill Lynch, 3 November 2010, p.5

[104] Notice of the State Administration of Foreign Exchange on Issues Concerning Reform of the Verification and Writing-off System of Foreign Exchange Payment for Imports (Hui Fa [2010] No.57 ("Circular 57"), effective from 1 December 2010.

For Grade A Importers

1. PRC Importer ("the Buyer") and the Foreign Seller ("the Seller") enter into an import sale contract denominated in a foreign currency (e.g. HKD). The Seller ships the goods to China's customs border

2. The Buyer makes import declaration with Customs, and settles customs duties and import VAT

3. The Buyer then clears the goods with Customs and the goods are released to the Buyer.

4. The Buyer then requests the Bank to remit payment out to the Seller in a foreign currency (according to contract).

5. Periodically, the Bank will report to SAFE these payments made by Grade A PRC importer, on behalf of the importer, and will work with SAFE for internal checking of these payments.

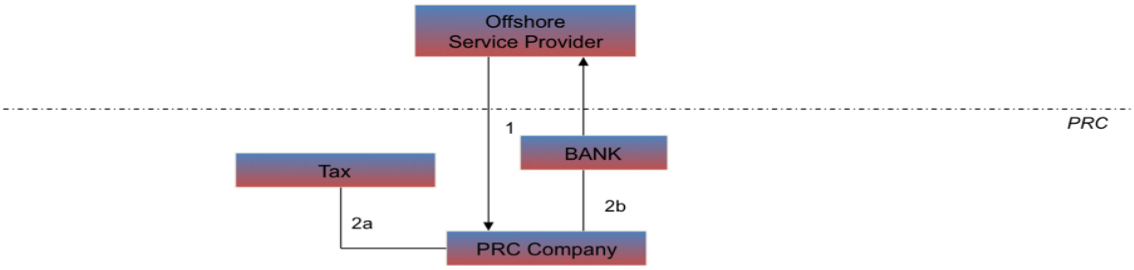
For Grade B and C Importers

Grade B and C Importers generally would follow the same procedures as Grade A importers, except that they would need to perform online filing and post transaction reporting with SAFE before and/or after Step 5 above (i.e. remittance of purchase proceeds). SAFE occasionally might pay visits to these importers as part of the risk monitoring exercise.[105]

[105] Chan, Daniel, Interview at DLA Piper Hong Kong on 28 February 2011

3.2.3 Outbound payment of service fees in foreign exchange

In addition to export and import transactions, all other cross border current account transactions are referred to as "non-trade" transactions in China, and these include the payment of service fees, rental, interests, dividends, royalties etc.[106] The cross border remittances in relation to these payments each would follow a different set of procedures and are different to those applicable to import and export transactions, depending on the nature of the remittances. The following is an illustration of the procedures regarding outward remittance of service fees in a foreign currency from China. For this procedure, the tax payment and remittance processes are segregated so that the bank does not have to be given the burden of monitoring whether tax has been paid for small amounts.



1. The Offshore Service Provider and the PRC Company will enter into a service agreement denominated in a foreign currency (e.g. HKD). The Offshore Service Provider provides service to PRC Company.

2. The PRC Company then proceeds to make the payment of service fees:

   a) If the payment amount is in excess USD 30,000, then the PRC Company needs to first pay the relevant withholding tax, if applicable, and obtain a Tax Clearance Certificate. On the strength of this Tax Clearance Certificate, the PRC Company can then proceed to the bank to request for remittance of the service fee in FX to the Foreign Seller.

   b) If the payment amount is less than USD 30,000, then the PRC Company needs not first go to tax bureau, but can directly approach the bank to have the amount wired out of China without the bank having to inspect the Tax Clearance Certificate as a prerequisite for remittance. (Note that the withholding tax nonetheless should still be paid to the tax bureau if it is payable.)

[106] Zee Winston K., *China Forex Handbook* Hong Kong, Asia Information Associates Ltd 1999, 59

Given China's objective to internationalize the RMB, China has put into place a Pilot Scheme to allow RMB to be used for settlement of cross-border trade. It is envisioned that the use of RMB as the settlement currency would benefit parties involved in the transaction by alleviating the costs and risks of exchange rate fluctuation as well,[107] as discussed later.

[107] Zheng, Jenny,& Zhu, Yuande,& Liu, Ya-Lan, *RMB cross-border trade settlement scheme: What are the potential implications?*, BBVA Economic Research Department, September 23 2009

4. THE STRUCTURE OF THE NEW RMB SETTLEMENT PILOT SCHEME

4.1 RMB Offshore Centre – Hong Kong

Under the 'one country, two systems' policy that was implemented after the Handover in 1997, Hong Kong and China have established a regulatory system that is built on mutual benefit with a high degree of financial cooperation.[108] Since 2004, the development of offshore RMB businesses in Hong Kong, although with limited scope[109], has provided a sound foundation for developing Hong Kong into an offshore RMB centre.[110] In fact, the State Council announced its support of promoting RMB business in Hong Kong in the so-called '30 Articles of Financial Policy', which promoted that financial transactions can be done freely[111] and RMB can be freely remitted anywhere in the world, once it is outside of China. Hong Kong is already the 'world's freest market for the RMB and RMB-denominated products, even more so than China's own onshore market' and much of the offshore RMB will navigate its way back to Hong Kong.[112] Additionally, Hong Kong already acts as a gateway of trade with China and has the required infrastructure, it is capable of becoming the offshore centre for cross-border trade settlement in RMB.[113] As a result, this will also provide confidence for trade participants to use RMB as a settlement currency.

Given this background, financial markets have termed the offshore RMB as 'CNH', the RMB deliverable primarily in Hong Kong that is freely quoted without intervention, and 'CNY' within China. Although the CNH and CNY are the same RMB, there is a 3% yield interest difference between the two.[114] In October 2010, the Hong Kong rate of the RMB against the USD was 2.5% higher than the fixed CNY rate.[115] This difference imposes significant RMB exposure to investors because this separation creates different supply and

[108] Li, Charles, *Six Questions Regarding the Internationalisation of the Renminbi*, September 21 2010
[109] *Personal Renminbi Business in Hong Kong,* HKMA Circular, February 5 2004
[110] Yue, Eddie, *Hong Kong as an International Financial Centre: The China Factor,* speech given at "Hong Kong: China's Global Financial Centre" Conference New York, March 1 2011
[111] Murase, Tetsuji, *Hong Kong Renminbi Offshore Market and Risks to the Chinese Economy,* Institute for International Monetary Affairs, December 7 2010 (No.40, 2010)
[112] *'Dim Sum' Development: Hong Kong Spurs an Offshore Renminbi Boom,* Knowledge Wharton University of Pennsylvania (online version) http://www.knowlegeatwharton.com.cn/index.cfm?fa=viewArticle&articleID=2357
[113] Li, Charles, *Six Questions Regarding the Internationalisation of the Renminbi*, September 21 2010
[114] Meier, Andre, IMF Representative and Speaker at 'The Renminbi's Changing Status and the Chinese and Hong Kong Financial Systems', CFRED Conference at CUHK, 11 August 2011
[115] Murase, Tetsuji, *Hong Kong Renminbi Offshore Market and Risks to the Chinese Economy,* Institute for International Monetary Affairs, December 7 2010 (No.40, 2010)

demand conditions.[116] By and large, the relative cross-border trade and service settlements determine the difference between the CNH and CNY rates.[117] As more RMB is released into the CNH market, it is inevitable that RMB liquidity will increase.[118] When this happens, it would create more economic stability to facilitate the opening up of the capital account convertibility when the liquidity of both the CNH and CNY pools are big enough to be unified into one pool.[119] At that stage, there is no need to distinguish between capital and current account transactions. Therefore, the establishment of the CNH market is integral to the overall development of the offshore RMB market therefore pushing the RMB into becoming an international reserve currency.

4.2 The Offshore RMB Settlement Pilot Scheme

The measures[120] and relevant implementation rules[121] of the Pilot Scheme were promulgated by the PBOC in July 2009, which allowed the RMB to be remitted offshore through trade transactions by allowing the cross-border trade transactions, including the import and export of goods[122] to be settled in RMB without going through SAFE foreign exchange verification and examination procedures. This is because foreign exchange payments are no longer involved. In other words, pilot enterprises need not submit the foreign exchange verification and examination form to Customs and State Tax Administration when handling customs declaration and tax refund for export of goods.[123] However, the receipt and payment under cross-border trade settlement in RMB is still subject to international receipt and payment statistics monitoring by SAFE. Accordingly, the pilot enterprises shall report each payment and receipt of RMB to SAFE within the timeframe through the bank system according to the SAFE Circular [2009] 90.[124] For pilot enterprises as a recipient of RMB, it shall report to the bank within five working days and for payers of RMB, it shall report to the

[116] Hui, Daniel,& Bunning, Dominic, *The offshore renminbi: A practical primer on the CNH market*, HSBC Global Research, December 1 2010, 2
[117] Ibid 4
[118] Chan, Daniel, Interview at DLA Piper Hong Kong on 28 February 2011
[119] Hui, Daniel,& Bunning, Dominic *The offshore renminbi: A practical primer on the CNH market*, HSBC Global Research, December 1 2010, 4
[120] Measures for Pilot Management of RMB Settlement for Cross-border Trade, July 1 2009
[121] Implementation Rules for Measures for Pilot Management of RMB Settlement for Cross-border Trade, July 3 2009
[122] Circular of the People's Bank of China, the Ministry of Finance, the Ministry of Commerce, the General Administration of Customs, the State Administration of Taxation and the China Banking Regulatory Commission on Issues Concerning Expansion of the Pilot Implementation of RMB Settlement in Cross-border Trade, June 17 2010 (PBOC Circular [2010] 186)
[123] Art 18, Measures for Pilot Management of RMB Settlement for Cross-border Trade, July 1 2009
[124] Circular of the General Affairs Department of the SAFE on Issues Concerning the Declaration of Balance of Payments Statistics for RMB Settlement of Cross-border Trade, July 6 2009

bank at the time when making the payment to foreign enterprises.[125] This Pilot Scheme was expected to provide new financial business opportunities for Hong Kong banks as well.[126]

Furthermore, the geographical coverage of the Pilot Scheme was expanded in July 2010[127], which led to a substantial growth of cross-border RMB trade settlement. Pursuant to this expansion, all Chinese enterprises within the pilot areas are qualified to settle in RMB for service with a foreign enterprise,[128] but the procedures for such payments are yet to be formalized. The total amount of cross-border trade settlement each month increased twenty-fold from RMB 4.5 billion in the first half of 2010, to more than RMB 87 billion in the fourth quarter.[129] This has driven the increase of the total amount of RMB deposits seven-fold since December 2009 amounting to RMB 407.7 billion in February 2011.[130] From these statistics, it is predicted that the use of RMB in cross-border current account transactions is likely to expand even more rapidly in the future and 'the wider use of RMB will greatly enhance all these bilateral trade and investment flows as it helps reduce currency conversion costs and exchange rate risks.'[131]

We now examine the detailed procedures of the cross-border transactions that can now be settled in RMB, which is largely similar to the procedures involving foreign exchange settlement. These transactions will be referred to as 'official channels' in this paper, which illustrates the first step China has taken towards internationalizing the RMB.

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[125] Art 22, Measures for Pilot Management of RMB Settlement for Cross-border Trade, July 1 2009

[126] External Department of Hong Kong Monetary Authority, *Renminbi Trade Settlement Pilot Scheme,* Hong Kong Monetary Authority Quarterly Bulletin, September 2009

[127] Yuen, Arthur K.H., *Renminbi Business in Hong Kong,* HKMA Circular, July 19 2010

[128] PBOC Circular [2010] 186

[129] Yue, Eddie, *Hong Kong as an International Financial Centre: The China Factor,* speech given at "Hong Kong: China's Global Financial Centre" Conference New York, March 1 2011

[130] Lui, Keith, *The Recent Developments of RMB Financial Products – a Regulatory Perspective,* Securities and Futures Commission Hong Kong, April 7 2011

[131] Chan, Norman, '*Showcasing Hong Kong as the offshore Renminbi centre'*, Press Release at the RMB Australasia Summit Sydney, March 17 2011

4.2.1 Inbound payment in relation to export of goods in RMB

Under the Pilot Scheme, the PRC exporter can receive payment for export transactions in RMB. However, only approved Chinese pilot enterprises in the 16 provinces (autonomous regions and municipalities) stated under PBOC Circular [2010] 186[132] may export goods and settle in RMB. These are Beijing, Tianjin, Inner Mongolia, Liaoning, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Hubei, Guangxi, Guangdong, Hainan, Chongqing, Sichuan, Yunnan provinces, municipal cities and autonomous regions. As of November 2010, 67,359 enterprises were participating in the Pilot Scheme already and the total RMB settlement was RMB 340 billion.[133] The local governments are responsible for approving the pilot enterprises according to their local qualification standard and procedures.[134] When the Pilot Scheme first came into effect in July 2009[135], the overseas RMB settlement business was only open to Hong Kong, Macau and countries in ASEAN (Association of Southeast Asian Nations) but it is now open to all countries. This drastic expansion of the Pilot Scheme would increase the trade volume with Hong Kong further while improving the cost structure and profit margin of Chinese exporters with a lower risk of exchange fluctuation[136].

The following procedures for export settlement in RMB highlight the elimination of this foreign exchange verification and examination process with SAFE.

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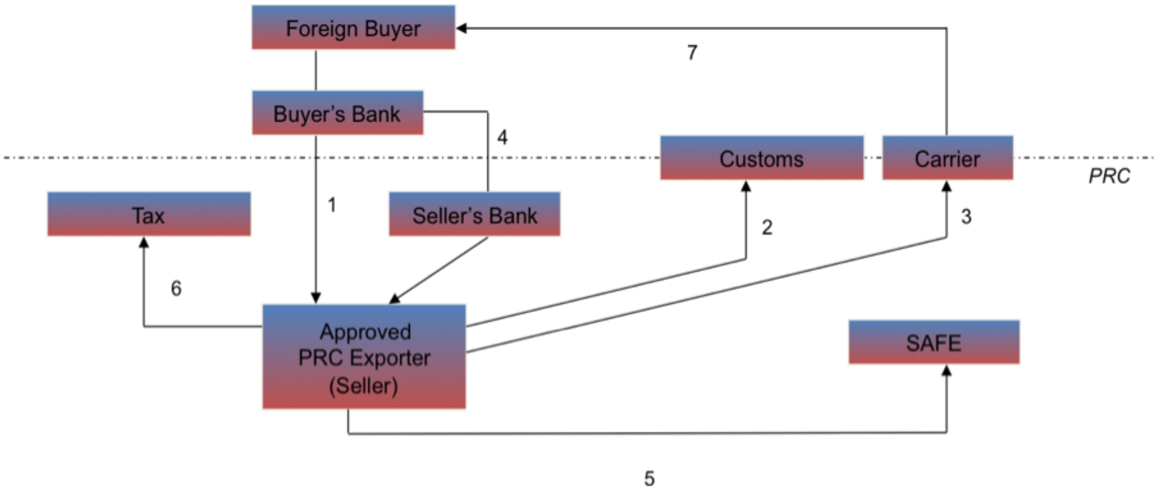
[132] PBOC Circular [2010] 186

[133] *积极支持企业开展跨境贸易人民币结算试点，促进贸易和投资便利化* PBOC Circular, December 12 2010 http://www.pbc.gov.cn/publish/huobizhengceersi/3131/2010/20101206184442957396214/20101206184442957396214_.html

[134] Zhejiang Local Government Cross-border Trade Settlement in RMB Circular [2010] 91

[135] Measures for the Administration of Pilot RMB Settlement in Cross-border Trade, 1 July 2009; Detailed Rules for the Implementation of the Measures for the Administration of Pilot RMB Settlement in Cross-border Trade, 3 July 2009

[136] Zheng, Jenny,& Zhu, Yuande,& Liu, Ya-Lan, *RMB cross-border trade settlement scheme: What are the potential implications?*, BBVA Economic Research Department, September 23 2009



1. The Approved PRC Exporter ("the Seller") and a Foreign Buyer ("the Buyer") enters into an export contract denominated in RMB. The Buyer's bank supplies a Letter of Credit to the Seller.

2. The Seller directly approaches Customs for Customs export clearance and making export customs declaration, filling in the corresponding details such as the RMB amount for the goods.

3. Once clearance is obtained, the Seller consigns the goods to a carrier in exchange for a Bill of Lading. The Seller sends the Bill of Lading to the Buyer's bank, which then passes it on to the Buyer in exchange for the payment.

4. The Buyer then remits RMB proceeds into the Seller's bank in the PRC as payment for the exported goods. The Seller then approaches the bank with the customs declaration forms, export contracts and invoices, and informs the bank that RMB payment is to be expected.

5. The Seller reports the RMB receipt to SAFE.

6. The Seller on the strength of the above documents (export declaration, contracts etc) still will be entitled to a refund of Input VAT upon export.[137] Yet, there are specific requirements issued by the tax authority in the Tax Circular [2010] 303:[138]

    a. The pilot enterprises need not provide the foreign exchange verification and examination form when applying for tax refund. However, they shall separately report to the competent tax authority with other supporting documents.

    b. In case of payment delay as set forth in Article 23 of the Pilot Measures, the tax authority may require the pilot enterprise to provide relevant data, information or written statement for foregoing supervision.

7. The Buyer provides the Bill of Lading to the carrier and takes delivery of the goods.

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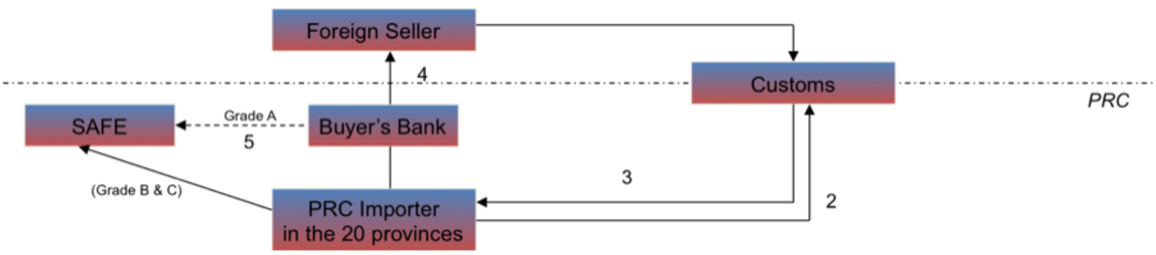
[137] Art 17, Measures for Pilot Management of RMB Settlement for Cross-border Trade, July 1 2009

[138] Circular of the State Administration of Taxation on Examination of the Pilot Enterprise and Tax Exemption (Refund) for Export of Goods in connection with Pilot Settlement in RMB for Cross-border Trade, June 29 2010

4.2.2 Outbound payment for import of goods in RMB

Similar to the export procedures under the Pilot Scheme, the PRC Importer can make outward remittance payment for import transactions in RMB. In fact, all Chinese enterprises within the 20 provinces (autonomous regions and municipalities) stated under PBOC Circular [2010] 186[139]are qualified to make payment in RMB with foreign exporters. These are Shanghai, Guangdong, Beijing, Tianjin, Inner Mongolia, Liaoning, Jilin, Heilongjiang, Jiangsu, Zhejiang, Fujian, Shandong, Hubei, Guangxi, Hainan, Chongqing, Sichuan, Yunnan, Xizang, and Xinjiang provinces, municipal cities and autonomous regions. According to the Hong Kong Trade Department Council (the "HKTDC") in 2011, over 85% of the transaction amount in cross-border RMB trade settlement is now related to imports.[140] This is because import enterprises in those 20 provinces can trade freely and there is also a "strong demand for RMB from overseas in view of the anticipation that RMB will appreciate in the mid and long term".[141]

The procedures for settlement of import transactions in RMB are very similar to remittances made in a foreign currency by the Grade A PRC Importer, as described below[142] Similarly, Grade B and C Importers would need to perform the extra online filing step after each payment.



[139] PBOC Circular [2010] 186
[140] *"Pilot Scheme for Cross-Border Trade Settlement extended"*, HKTDC January 1 2011
[141] Ibid.
[142] Notice of the State Administration of Foreign Exchange on Issues Concerning Reform of the Verification and Writing-off System of Foreign Exchange Payment for Imports (Hui Fa [2010] No.57 ("Circular 57"), effective from 1 December 2010.

For Grade A Importers

1. PRC Importer ("the Buyer") and the Foreign Seller ("the Seller") enter into an import sale contract denominated in RMB. The Seller ships the goods to China's customs border.

2. The Buyer makes import declaration with Customs, and settles customs duties and import VAT

3. The Buyer then clears the goods with Customs and the goods will be released the Buyer.

4. PRC Importer then requests the Bank to remit payment out to the Foreign Seller in RMB (according to contract).

5. Periodically, the Bank will report to SAFE these payments made by Grade A PRC Importer and will work with SAFE for internal checking of these payments.

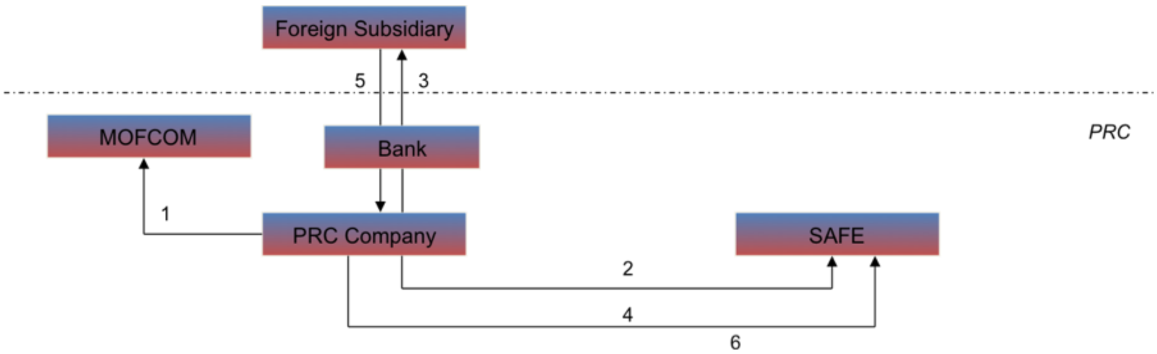
4.2.3 Outbound payment of service fees in RMB

Under the PBOC Circular [2010] 186, PRC Companies can now pay for offshore service providers in RMB, as a current account transaction. However, there are currently no published guidelines to the PRC banks as to what procedures are to be followed for cross-border service. According to the Bank of China ("BOC"), Industrial and Commercial Bank of China ("ICBC"), and Hong Kong and Shanghai Bank Corporation ("HSBC") in Shanghai, they currently have adopted procedures almost identical to those applicable to remittances of service fees in a foreign currency.[143] There is still a requirement to pay withholding tax for the offshore services provided. Additionally, if the payment in RMB is more than the equivalent of USD 30,000, the PRC Company will have to show the Tax Clearance Certificate to the bank in order to process the payment offshore. It is anticipated that these procedures will be formalized in the near future as this route of payment becomes more popular.

[143] Chan, Daniel, Interview at DLA Piper Hong Kong on 28 February 2011

4.2.4 Capital Account: Overseas Direct Investments (ODI) out of China in RMB

The latest expansion of the Pilot Scheme in January 2011 covers capital account transactions in the form of ODI made by approved Chinese enterprises.[144] The investment has to be approved by the investment authorities in the foreign country and the local SAFE must approve the remittance of RMB by installment or lump sum. This is the first step China has taken to open up capital account transactions but evidently it is still tightly regulated by SAFE. Nonetheless, China's ODI amounted to USD 56.5 billion in 2009 of which 63% was invested in Hong Kong or through Hong Kong to other countries.[145] This supports the fact that Hong Kong is a prominent offshore RMB centre. The procedures are as follows:



1. The PRC Company applies and obtains an approval letter from the Ministry of Commerce in China for the ODI.
2. The ODI is registered with SAFE.
3. The PRC Company wires RMB to the foreign subsidiary with the bank.
4. The PRC Company reports the remittance of RMB to SAFE.
5. The foreign subsidiary remits profit in RMB back to China through the bank to the PRC Company.
6. The PRC Company reports the receipt of RMB to SAFE.

144 Administrative Measures for the Pilot RMB Settlement of Overseas Direct Investment, No.1 [2011], January 6 2011

145 *Pilot Scheme for settlement of overseas direct investments in Renminbi*, HKMA Press Release, January 13 2011

4.2.5 Capital Account: Qualified Foreign Institutional Investor (QFII) and Qualified Domestic Institutional Investor (QDII) in RMB

In 2009, a total of 79 foreign institutional investors have been approved to buy and sell domestic Chinese stocks, equities and bonds under the QFII scheme. [146] This scheme started in 2003 and recently the quota under the scheme was tripled to US$30 billion.[147] The requirements for foreign investors to qualify as QFII are set out in the *Regulation on Domestic Securities Investment by Qualified Foreign Institutional Investor*[148]. However, the QFII scheme uses USD to participate in China's capital markets, which is not promoting RMB internationalization to the fullest. Thus, the Chinese Government proposed the "Mini-QFII" Scheme in September 2010 to open up new channels of investment for RMB deposits held offshore, especially in Hong Kong where robust growth of RMB deposits have been recorded, thereby reducing China's reliance on the USD. The Securities and Futures Commission (the "SFC") in Hong Kong will be the main regulator of this new scheme and be subject to Hong Kong law. The Chairman of the China Securities Regulatory Commission (the "CSRC") stated that this Mini-QFII Pilot Scheme would push for 'closer cooperation between China and Hong Kong capital markets and increase the scope of development with the Hong Kong Stock Exchange.'[149] However, the exact implementation date is not confirmed yet; the Chinese authorities do not think it is appropriate for the Mini-QFII Pilot Scheme to come into force yet but it is predicted to happen in the near future.[150]

On the other hand, domestic Chinese investors can invest in foreign securities markets through certain fund management institutions, insurance companies, securities companies that are approved by the CSRC.[151] This QDII scheme was set up partly to provide the growing number of domestic investors with a place to park their funds; only a few hundred local stocks are listed on the Shanghai and Shenzhen stock exchanges. Therefore under this scheme, Chinese individuals can also invest in the US and HK stock markets[152]. In 2006 the Chinese government extended this scheme to cover Chinese commercial banks as well to help Chinese

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146 Wan Hanny, Legg Mason Seeks China License to Trade Yuan-Denominated Stocks, 10 March 2009 http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aM4E27602pNU

147 Ibid.

148 合格境外机构投资者境内证券投资管理办法, 1 September 2006

149 *China Securities Regulator to Launch Mini-QFII Soon*, Business China, 18 Jan 2011 http://en.21cbh.com/HTML/2011-1-18/QFII.html

150 Feldman, Matthias, Speaker at 'The Renminbi's Changing Status and the Chinese and Hong Kong Financial Systems', CFRED Conference at CUHK, 13 August 2011

151 Yu, Zhang, *Brief Introduction to QFII and QDII in China*, 7 April 2011

152 Komaiko, Richard, *US stocks open to China savers*, Asia Times Online, 10 April 2008 http://www.atimes.com/atimes/China_Business/JD10Cb01.html

institutions and residents invest in foreign financial products, but this was limited to fixed-income and money market products.[153] The scope of the scheme was further expanded in 2007, where investors can also invest in stock related products with certain restrictions - the net value of a QDII product must not exceed 50%, with the net value represented by a single stock capped at 5%.[154] Commentators say that the QDII scheme acts as a catalyst to Hong Kong's stock market due to the geographical convenience to China and the increasing number of Chinese investors wanting to invest overseas.[155] Thus, the development of QFII and QDII will lead to more widespread use of the RMB.

[153] *Chinese Banking Watchdog Grants QDII Status to 17 Banks,* Xinhua News Agency, 1 December 2006
[154] Yu Zhang, *Brief Introduction to QFII and QDII in China*, 7 April 2011
[155] Hui, Taylor, *Chinese Investors Allowed to Invest in Overseas Equities and Mutual Funds under QDII Scheme*, Deacons Financial Services, May 2007

4.2.6 Capital Account: Foreign Direct Investment (FDI) into China in RMB

Since July 2007, the first wave of RMB bonds in Hong Kong was issued to help develop the bond market in Hong Kong where the China Development Bank issued RMB 5 billion worth of securities.[156] This was followed by debts issued by BOC in September 2007 and 2008, the Bank of Communications in July 2008 and China Construction Bank in August 2008.[157] However, RMB deposit holders seem to have nowhere else to invest their RMB outside of Hong Kong. Although there are currently no published regulations permitting foreign direct investment into China in RMB, banks in Hong Kong and Macau were allowed to re-invest their offshore RMB proceeds into the onshore interbank bond market in August 2010. This allowed the banks to gain more returns than squaring off their funds with the Clearing Bank, which is the Bank of China in Hong Kong ("BOCHK").[158] This is a bold move made by the PBOC to encourage Participating Banks**[159]** to increase offshore RMB liquidity. At this pace, it is predicted that the Pilot Scheme soon will also formally cover FDI into China in the future[160] as the pool of offshore RMB funds in Hong Kong continue to grow. All in all, these developments are gradually advancing the RMB to satisfy the requirements in becoming an international reserve currency.

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[156] *How Significant Are Chinese Steps Toward Internationalization of the Renminbi?*, Roubini Global Economics September 11 2010, 7 (online version)[URL to be inserted]

[157] Ibid.

[158] Lee, Georgina, *China fast-tracks Hong Kong as offshore renminbi center*, Asia Risk, September 10 2010

[159] Banks in Hong Kong that have signed a Clearing Agreement with the Bank of China Hong Kong and can take deposits from and offer conversion services to enterprises and individuals carrying out RMB cross-border trade transactions.

[160] 跨境贸易人民币结算业务渐热, Sinoft, March 2 2010 http://www.sinotf.com/GB/International_Settlement/1201/2010-03-02/wNMDAwMDA0OTIwNA.html

4.3 The Hong Kong Banking System

Before the Pilot Scheme was implemented, only foreign exchange derived from current account transactions can flow in and out of China. These transactions can now be settled in RMB, which can now flow in and out of China through the official channels. The bulk of the RMB will be remitted through the banking system into Hong Kong. This comprises of the CNH pool, in addition to the offshore RMB in circulation that are derived from the black-market or hand carried across the border.[161] Chinese enterprises that are approved by SAFE, corporate customers and individuals can open RMB deposit accounts at Hong Kong Participating Banks, and are subject to Hong Kong Banking Rules.[162] The Participating Banks offer conversion services to their customers, but to the extent of this actually depends on the mirroring rules it has with the Hong Kong Clearing Bank, the BOCHK , that was set up by PBOC in December 2003 under a Clearing Agreement, so they will not take on extra credit risks.[163]

A revised Clearing Agreement was signed between the PBOC and Hong Kong Monetary Authority (the "HKMA") on 19 July 2010 to promote the expansion of RMB business in Hong Kong, lifting the restrictions on the Participating Banks to establish RMB accounts and providing related services for financial institutions as well as allowing individual and corporate customers also to conduct RMB payments and transfers through the banks. [164] This service would cater to the individuals who want to buy RMB to invest or hedge against the future as well as purchasers of RMB-denominated products, or 'dim sum bonds', that are currently being offered in the market. However, individuals are still subject to a daily limit of RMB 20,000 of conversion services and up to RMB 80,000 remittance to their own account in China. At the same time, corporate customers can convert RMB into other currencies without a cap.[165] The PBOC and HKMA's intentions are to boost offshore RMB circulation in Hong Kong.[166]

Subsequently, if the RMB deposits originate from the official channels, the Participating Banks can square off their long or short open positions with the Clearing Bank in

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[161] Chan, Daniel, Interview at DLA Piper Hong Kong on 28 February 2011
[162] *'Renminbi Business in Hong Kong'* HKMA Circular, July 6 2010
[163] Ibid.
[164] Xinhua, '*Mainland, HK sign revised clearing agreement for Chinese RMB business in HK'*, People's Daily Online, China, 19 July 2010 (online version)[URL to be inserted]
[165] *RMB cross-border trade settlement and net open position*, HKMA Circular, December 23 2010
[166] Lee, Georgina, *China fast-tracks Hong Kong as offshore renminbi center*, Asia Risk, September 10 2010

Hong Kong. The RMB net open position was defined by the HKMA, the supervisory authority of the Participating Banks, as 'the difference between on-balance sheet RMB assets and liabilities, but excluding any RMB structural position e.g. investment in Chinese subsidiary banks', and Participating Banks are advised to keep their net open positions low in order to manage their foreign exchange risks.[167] Further guidelines were provided by the HKMA, which took effect on January 1 2011, where such exchange transactions with the RMB Clearing Bank can only be done within three months from the date of transaction, and should be done by the same Participating Bank the RMB was initially deposited at.[168] Otherwise, the RMB deposits will not be eligible for position squaring with the RMB Clearing Bank. This is the first arrangement for RMB trade settlement, and the most typical arrangement. In effect, the Participating Banks' risk of exposure to foreign exchange fluctuation is kept to the minimum[169] as it is almost 100% guaranteed that the Clearing Bank would buy or sell the RMB originating from the official channels. Thus, the mechanics of trade settlement in RMB is largely dependent on the conversion services offered by the Hong Kong Clearing Bank. Alternatively, transactions relating to trade, services and ODI settled in RMB between pilot enterprises and overseas companies can also be cleared through commercial banks in China acting on behalf of overseas commercial banks.[170]

However, for both arrangements, the Hong Kong Participating Banks and CNH Corresponding Banks in China will have to apply for RMB open position limits from the PBOC and comply with the relevant legal and regulatory requirements.[171] In October 2010, BOCHK was given an annual quota of RMB 8 billion but this was fully depleted within four months[172]. In fact, China is using this quota to control how much RMB would be leaked out so as to minimize liquidity and credit risks with the Hong Kong Participating Banks[173] and manage the pace of the offshore RMB development.[174] In response to this, the HKMA has arranged for the Shanghai Clearing Bank to conduct RMB conversions and will also provide

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167 *RMB cross-border trade settlement and net open position,* HKMA Circular, December 23 2010
168 Ibid.
169 Yuen, Arthur K.H., *Renminbi Business in Hong Kong,* HKMA Circular, July 19 2010
170 Measures for Pilot Management of RMB Settlement for Cross-border Trade, July 1 2009
171 *'Renminbi Business in Hong Kong'* HKMA Circular, July 6 2010
172 Lam, Jeffrey Hon, Professor Chan K. C., *LCQ3: Development of Hong Kong as an offshore Renminbi business centre,* Press Release, January 12 2011
173 Geva, Benhamin, *Promoting Stability in International Finance – Legislation and Regulatory Reform of Payment and Settlement Systems* in Rosa M Lastraed, *The Reform of the International Finance Architecture* London: Kluwer Law International, 2000, 198
174 Hui, Daniel,& Bunning, Dominic, *The offshore renminbi: A practical primer on the CNH market,* HSBC Global Research, December 1 2010, 8

RMB 20 billion as a standing arrangement for cross-border trade settlements through its Currency Swap Agreement with PBOC.[175] Participating Banks can apply for this fund but the exchange transactions should be due for settlement within three months from the date of transaction, which is same as the requirement with RMB clearing banks.[176] These are the other alternatives for the supply of RMB funding. In circumstances where the RMB deposits does not originate from the official channels, Participating Banks can rely on the secondary interbank system or even non-participating banks in dealing with the RMB deposits, as well as other market participants. However, this effectiveness of this supplementary market very much depends on the supply and liquidity of RMB in the market.

As more and more RMB is remitted in to the CNH pool, people will become more accustomed to using the RMB and eventually develop confidence in the currency. Market participants holding CNH can purchase RMB bonds or invest it back into China, or even hold long positions in anticipation for it to appreciate in the future. Therefore, we are now witnessing the tidal front of this global phenomenon of the internationalization of the RMB as an international reserve currency.

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175 Lam, Jeffrey Hon, Professor Chan K. C., *LCQ3: Development of Hong Kong as an offshore Renminbi business centre,* Press Release, January 12 2011

176 *RMB cross-border trade settlement and net open position,* HKMA Circular, December 23 2010

5. ASSESSMENT OF THE PILOT SCHEME

Under the Pilot Scheme, RMB is allowed to flow in and out of China through the official channels without restrictions, as long as the RMB is used for trade, service and ODI purposes and that the Chinese enterprises satisfy the procedural requirements. This breakthrough marks the beginning of 'unprecedented opportunities' offered by China to market players and it is imperative for them to be well prepared.[177] By the end of 2010, trade settlement in RMB amounted to RMB 87 billion in Hong Kong per month[178] but the HKMA still considers this sum to be quite small[179]. Li stated that 'The interim objective before the capital account is fully open is how to stimulate these outflows and inflows'[180] and in August 2010, the PBOC announced that foreign commercial and central banks would be allowed to invest in the domestic bond market to increase the inflows and outflows of RMB.[181] Nonetheless, the advantages of using RMB as the settlement currency is counteracted by the limited investment use of offshore RMB internationally today,[182] and that capital account transactions are still subject to approval. Therefore, China is still at the infancy stage of internationalizing the RMB.

The increasing trend of the net inflow and outflow on RMB trade, since July 2009, can be explained by the incentives for traders and corporates to settle in RMB instead of foreign exchange. For the export of goods, the elimination of foreign exchange documentation reducing costs in the supply chain as the settlement cycle become shorter and suppliers can receive faster tax rebates from the tax authorities.[183] This would also enhance supplier-buyer relationships and allow traders to manage the timing and control of the settlement cycles. Also, there is an increased pricing transparency for cross-border trade and service transactions as goods and services can now be priced and settled in RMB without any potential mark up from foreign exchange.[184] Thus, the Pilot Scheme can be used to access a wider supplier base that might have limited access to foreign currency. More importantly, traders will experience

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177 Yue, Eddie, *Hong Kong as an International Financial Centre: The China Factor,* speech given at "Hong Kong: China's Global Financial Centre" Conference New York, March 1 2011

178 Lui, Keith, *The Recent Developments of RMB Financial Products – a Regulatory Perspective,* Securities and Futures Commission Hong Kong, April 7 2011

179 Lee, Paul, Interview at DLA Piper on 24 March 2011

180 Li, Charles, *Six Questions Regarding the Internationalisation of the Renminbi*, September 21 2010

181 *How Significant are Chinese Steps Towards Internationalization of the Renminbi?,* Roubini Global Economics September 11 2010, 3

182 *China takes another step towards internationalization of its currency,* Analysis BBVA Research August 30 2010

183 *RMB Settlement,* Standard Chartered Bank http://wholesalebanking.standardchartered.com/en/capabilities/transactionbanking/Pages/rmb.aspx

184 Ibid.

a reduced risk of foreign exchange exposure and market volatility by using RMB as opposed to settling with a currency of the third country, which is made more attractive by the fact that exchange notes experienced tremendous fluctuations during the financial crisis.[185] This would also lower the transaction costs, as traders will not have to go through double foreign currency conversions in one transaction. In fact, holding a RMB cash position would further reduce risk for sellers to China as it is a natural hedge for two-way import and export flows with China. Overall, all these benefits stemming from the introduction of the Pilot Scheme will definitely attract more enterprises engaging in cross-border trade to use RMB as the settlement currency.

On the other hand, we note that there does not appear to be significant savings on administrative work in relation to the remittance procedures for the trade and service transactions. It seems that and companies undertaking these current account transactions seem to be drawn to the other benefits the Pilot Scheme entails. The reason could be that the complexity of the export and import procedures remains similar even though the foreign exchange verification and examination system is no longer relevant in the export procedures. Also, the limitations of remittance of service fees also remain the same, except that it is carried out in RMB. Payments from PRC customers involved in current account transactions are often delayed by the withholding tax procedures, and these too remain unchanged in the Pilot Scheme.[186] Similarly, the ODI transactions are still subject to very stringent controls and approval is required by the Ministry of Commerce and SAFE. Thus, it is evident that China is still experimenting with the Pilot Schemes and gradually expanding them while still involving optimum government controls to ensure financial stability. This could be seen as a lesson learnt from the financial crisis in 1997.

Furthermore, the success of the Pilot Scheme requires coordination between the regulatory bodies in Hong Kong and China. It also requires the seamless integration of the clearing and settlement systems in both places.[187] The PBOC acts as the major monitoring system of the flow of RMB through the Pilot Scheme that is put into place between China and Hong Kong. In October 2010, the PBOC imposed a RMB 8 billion quota on the Hong Kong Clearing Bank to manage their liquidity and credit risks with the Hong Kong Participating

[185] Chan, Daniel, Interview at DLA Piper Hong Kong on 28 February 2011
[186] Ibid.
[187] Ho, Candy C.Y., *Renminbi Cross-Border Payment Arrangement*, 25 Banking and Finance Law Review 435 June 2010, 10

Banks. This intended to ensure economic stability and to support the countries' fund transfer system.[188] Also, the liquidity of the participating banks is monitored on a real time basis by the Payment Management Information System (the "PMIS"), which allows the PBOC to oversee the RMB fund flows and to control the operation of the clearing system.[189] Moreover, under the *Clearing and Settlement Systems Ordinance* (the "CSSO")[190], the HKMA has the power to oversee and designate the clearing and settlement systems in Hong Kong. This system is very important in shaping of Hong Kong's financial infrastructure, which is closely supervised by the Central Banks in China.[191] As Hong Kong has developed into a prominent RMB offshore centre, market participants are assured and confident to switch their settlement currency for trade, service and ODI to RMB.

The further development of the RMB offshore centre is still subject to the supply and liquidity of RMB outside of China.[192] A lot is being done to increase the liquidity of the offshore spot market in addition to the expansion of the Pilot Scheme. Firstly, Hong Kong banks have been paying higher interest rates to RMB deposits than HKD deposits since November 2008[193] to attract offshore RMB. Secondly, as a huge variety of RMB denominated products such as dim sum bonds, have been introduced into the market. Investors who are speculating on the appreciation of the RMB will have more incentive to buy such products. Banks are aiming to increase offshore liquidity through these RMB products, as corporate customers will get a high enough return rate to balance off their borrowing costs in RMB.[194] In fact, it was estimated by HSBC that new 'dim sum bond' issues would reach RMB 80 billion in 2011.[195] Alternatively, it has been suggested by Joseph Yam that in order to increase RMB liquidity in Hong Kong, the Clearing Bank (BOCHK), can create RMB as though it is a central bank, by crediting the Participating Bank's settlement accounts with it.[196] Therefore, it is predicted that the supply and liquidity of the CNH pool will 'grow organically

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[188] Geva, Benhamin, *Promoting Stability in International Finance – Legislation and Regulatory Reform of Payment and Settlement Systems* in Rosa M Lastra ed, *The Reform of the International Finance Architecture* London: Kluwer Law International, 2000, 198

[189] People's Bank of China, 2007 *China Payment System Development Report,* Financial Service Report No.5 (2008) [PBOC Report No.5]

[190] Clearing and Settlement Systems Ordinance 2004 (HK), c.584

[191] Ho, Candy C.Y., *Renminbi Cross-Border Payment Arrangement*, 25 Banking and Finance Law Review 435 June 2010, 10

[192] Lee, Georgina, *China fast-tracks Hong Kong as offshore renminbi center*, Asia Risk, September 10 2010

[193] Leung, Chris *How far can Hong Kong go as China's Major Renminbi Offshore Center?,* Analysis DBS Group Research August 10 2010

[194] Lee, Georgina, *China fast-tracks Hong Kong as offshore renminbi center*, Asia Risk, September 10 2010

[195] *'Dim Sum' Development: Hong Kong Spurs an Offshore Renminbi Boom,* Knowledge Wharton University of Pennsylvania (online version) www.knowlegeatwharton.com.cn/index.cfm?fa=viewArticle&articleID=2357

[196] Lee, Georgina, *China fast-tracks Hong Kong as offshore renminbi center*, Asia Risk, September 10 2010

over time'[197]. This would in effect further stabilize the economy, so that one day the Pilot Scheme can generate enough liquidity to achieve China's objective in becoming an international reserve currency.

Finally, another issue arises when the offshore RMB deposits build up in Hong Kong and find little investment uses internationally. An obvious use for such RMB is to send it back to China through the official channels. However, the channels for capital account transactions are still not yet widely open due to the requirement for approval. Full capital account convertibility is a prerequisite for the RMB to become an international reserve currency, and a possible alternative to the US Dollar.[198] This is predicted to happen when the CNH and CNY pools merge together. China's attitude in this area of reform is emphasized on "gradualism, coordinated planning and tackling easier areas before more difficult ones and reserving grounds", as described by SAFE[199]. Thus, it seems that China is slowly putting together the pieces of the puzzle towards the RMB's potential as an international reserve currency, while maintaining its capital account controls and causing the least possible impact on its onshore capital markets.[200] To sum up, the RMB is gradually achieving the characteristics of being a medium of exchange and store of value. It is continuously gaining international confidence that is supported by a robust capital market and high liquidity in the market, that were set out in the first part of this paper.

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[197] *'Dim Sum' Development: Hong Kong Spurs an Offshore Renminbi Boom,* Knowledge Wharton University of Pennsylvania (online version) www.knowlegeatwharton.com.cn/index.cfm?fa=viewArticle&articleID=2357

[198] Ibid.

[199] Yam, Joseph, 'A Safe Approach to Convertibility of the Renminbi', April 6 2011, 7

[200] Li, Charles, *Six Questions Regarding the Internationalisation of the Renminbi*, September 21 2010

6. CONCLUSION

Today, 75% of China's trade settlement is done in Hong Kong[201] and this clearly demonstrates the strong preference of market players for making use of Hong Kong's relatively more stable and transparent platform for RMB trade settlement. It is expected that the Pilot Scheme for the settlement of trade, services and ODI in RMB will facilitate Hong Kong's offshore RMB market development[202]. In a Goldman Sachs report, it was predicted that in the next five years the amount of RMB deposits in Hong Kong will reach RMB 3.5 trillion, which will account for 31.6% of the total deposits in the Hong Kong banking system.[203] This would be largely driven by the incentive of reducing the risk of foreign exchange exposure and conversion costs when using the RMB as a settlement currency for traders participating in the Pilot Scheme, and there is now an increasingly widespread use of the RMB as the confidence behind the currency increase. However, there is still a long way to go before the globalization of the RMB currency and capital account convertibility can be achieved. China has taken the first few steps towards this journey, and at the same time, Hong Kong has gained significant economic benefits from this development.

Nevertheless, Hong Kong has no intention of linking its Hong Kong Dollar with the RMB at the moment, because China has not achieved full capital account convertibility and the asset markets in China are not wide, deep and liquid enough.[204] However, this may happen in the future when more RMB denominated products are introduced into the Hong Kong and international markets and when foreign direct investment in RMB will be allowed into China. At this stage, the offshore RMB liquidity would have increased so that the CNH and CNY pools can be merged into one RMB pool. Therefore, when the RMB becomes freely convertible in Hong Kong, it may undermine the rationale behind the linkage of the HK Dollar with the USD. Also, given Hong Kong close ties with China, experts have said that " 'Renminbization' will indeed be the end game for the HK Dollar" in the future.[205] But this will only happen for the right political reasons and economic conditions as the CNH pool continues to grow.

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[201] Yue, Eddie, *Hong Kong as an International Financial Centre: The China Factor,* speech given at "Hong Kong: China's Global Financial Centre" Conference New York, March 1 2011

[202] *'Pilot Scheme to boost RMB growth' http://www.*news.gov.hk, January 15 2011 (online version)

[203] Li, Charles, *Six Questions Regarding the Internationalisation of the Renminbi*, September 21 2010

[204] Chan K. C., *LCQ3: Development of Hong Kong as an offshore Renminbi business centre,* Press Release, January 12 2011

[205] *'Dim Sum' Development: Hong Kong Spurs an Offshore Renminbi Boom,* Knowledge Wharton University of Pennsylvania (online version) www.knowlegeatwharton.com.cn/index.cfm?fa=viewArticle&articleID=2357

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