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The Role of Offshore Financial Centers in the Process of Renminbi Internationalization

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Abstract

The People's Republic of China (PRC) has been quite aggressive recently in promoting the international use of its currency, the renminbi. Historical experience suggests that an active offshore market is essential for a global currency. Indeed, anecdotal evidence affirms the role of offshore markets in pushing the renminbi currency to the world. One should not, however, overplay the contribution of offshore markets. While offshore markets offer the opportunities to experiment with the global use of the currency, the overseas acceptance of the renminbi is ultimately determined by both internal and external economic forces, and geopolitical factors. With its relatively small size, the offshore renminbi is not likely to pressure the PRC and alter its financial liberalization policy. A well-organized offshore renminbi market will complement the PRC's renminbi internationalization policy, but it is not possible to raise the currency's global status beyond the level justified by its economic and political attributes.

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1. INTRODUCTION

Financial crises highlight the vulnerability of economic systems and feed on the weakness of market designs. One of the lessons from the recent (2007–2008) global financial crisis is the danger of building the international monetary architecture around a single dominating global currency. Specifically, the shortage of the United States (US) dollar that occurred in the midst of the recent crisis has led to turmoil in the global financial market and has severely hampered international trade and financial transactions. The cataclysmic effects of the dollar shortage have alarmed the world that the current dollar-dominated international monetary system could be the lion's den.

In response to the global liquidity contraction experience, the People's Republic of China (PRC) has launched a number of initiatives to reduce its reliance on the US dollar and seek the use of its currency, the renminbi (RMB), in conducting international transactions. In light of its growing economic prowess in the global market, the PRC pushing the RMB into the international arena seems quite natural. An International Monetary Fund (2010) study, for example, considered the RMB one of the three national currencies that could compete with the US dollar in the global market—the other two currencies are the euro and the yen. The international acceptance of the RMB is partly made possible by the call for the US dollar to play a less prominent role, the occurrence of the European sovereign debt crisis, and Japan's two lost decades.

Both policy makers and academics are interested in unraveling the motivation behind these RMB internationalization initiatives. Some suggested motivations include that (i) it is driven by economic pragmatism in the midst of a dollar shortage crisis, (ii) it is a disguised component of the PRC's financial development policy, and (iii) it is an attempt to undercut the US dollar's supremacy in the global market. Disregarding what the true motivation is, it is generally agreed that the integration of the RMB into the global monetary system would greatly change the international economic and geopolitical landscapes.[1]

In addition to motivation, the world is watching the way the PRC is seeking to internationalize the use of its currency. In the last few years, the PRC has pursued a seemingly unorthodox approach to advance the role of its currency in the global market. Specifically, one main component of the general policy has been to establish offshore RMB markets, especially the one in Hong Kong, China. The offshore RMB market in Hong Kong, China was conceived in 2004. The offshore market made relatively slow progress in the few years after its inception. After the recent global financial crisis, the efforts on widening and deepening the offshore RMB market have been intensified. More recently, the PRC has been working with other financial centers including London and Singapore to promote offshore RMB businesses.

Does the presence of offshore markets help establish the global status of a currency? For instance, it is hard to conceive that the US dollar could achieve and maintain its prominent global role without the support of fully fledged offshore US dollar markets around the globe. At the minimum, offshore markets allow a currency to perform its potential as an international currency outside the country in which it is issued.

In the case of the RMB, a natural question to ask is: To what extent will the process of internationalization be facilitated by the newly developed offshore RMB market? Conceptually, one conceives that, for nonresidents, there is an optimal demand for

[1] See, for example, Eichengreen (2013), McCauley (2011), and Yu (2012) for recent discussions on RMB internationalization.

international transactions conducted in the PRC's currency. The establishment of an offshore market obviously allows nonresidents to conduct transactions in RMB. Nevertheless, will the level of RMB activity go beyond what is justified by overseas demand of such activity?[2] Will the offshore market push the RMB to the world beyond what is warranted by the global demand?

The role of offshore RMB markets deserves some attention. By and large, an offshore market and the international role of a currency are believed to be determined by market forces and exhibit economies of scale. However, in the case of the RMB, the PRC assumes an active policy stance in establishing offshore RMB markets, and in orchestrating and promoting its use overseas.

The nonconventional strategy has drawn both praise and skepticism. In a nutshell, some analysts believe that the offshore market approach is a clever maneuver in view of the relatively underdeveloped domestic financial market and the strong domestic resistance to the liberalization of financial markets. The offshore experiences could be brought back to the domestic market to further the liberalization policy. That is, the offshore market approach functions as a backdoor to advance financial market reforms. The PRC's 2001 accession to the World Trade Organization is an often cited example of the country's efforts to affirm and deepen its domestic economic reforms via opening up to world trade.

Skeptics, on the other hand, note that without a well-functioning domestic finance sector, offshore RMB markets could create unbalanced growth forces in the domestic and offshore markets, and the unbalanced growth could lead to adverse economic consequences in the medium to long run. In the short run, arbitrage across domestic and offshore markets imposes significant costs on the PRC. Furthermore, the prevailing capital control practices confine the scope of integrating successful experiences from offshore markets to the underdeveloped and heavily regulated domestic finance sector, and limit the growth of offshore RMB businesses.

Against this backdrop, we would like to assess the role of offshore RMB markets in promoting the international use of the RMB and some related issues. Besides providing a marketplace for the RMB to play the role of an international currency, could the offshore market "force" the PRC to deepen reform of its domestic finance sector and capital account policy? That is, would the PRC respond to the feedback from the newly developed offshore RMB markets? Or is the PRC able and willing to direct and dictate the process of financial liberalization and the related RMB internationalization policy?

In the next section, we offer some general discussion on offshore currency markets and global currencies. Section 3 focuses on the offshore RMB markets, with special attention on the one in Hong Kong, China. The recent developments in the PRC, including the launching of the Qianhai initiative in Shenzhen and the Pilot Free Trade Zone program in Shanghai, are discussed in Section 4. Section 5 offers some views on the limited roles of offshore markets in the RMB internationalization process. Some concluding remarks on the prospects of offshore markets and the internationalization of the currency are presented in Section 6.

[2] For simplicity, we ignore the possible ambiguities arising from the transition to the optimal level.

2. OFFSHORE CURRENCY MARKETS AND GLOBAL CURRENCIES

An exact definition of offshore financial centers is not that straightforward.[3] For the purposes of our discussion, we consider an offshore currency market to be a market that facilitates and specializes in transactions of products denominated in currencies not issued by the jurisdiction in which the market is located. It is noted that an offshore currency market is not limited to foreign exchange transactions and, due to the nature of offshore business, serves a disproportionally large nonresident population.

A main feature of an offshore currency market is that it separates the currency risk from the country risk. The currency risk is then combined with the risk of the country in which the offshore market is located. Usually, an offshore market is established in a country with a good reputation in the rule of law, sound financial market infrastructure, and favorable regulatory and tax policies on offshore transactions.

The pros and cons of an offshore currency market can be summarized as follows: All else equal, an offshore market adds overall liquidity to the currency. Besides the separation of the currency risk and the country risk, an offshore currency market offers a means to bypass rules and regulations in the onshore market. Added to regulation avoidance, participants could enjoy diversification and management advantages related to the time zone and location, language, and business environment of an offshore center. Because of differential regulatory requirements, especially those related to reserve requirements, pricing is typically quite competitive in offshore—relative to onshore—markets.

The usual concern on the cost is that a loosely regulated offshore market could induce monetary and financial instability because it amplifies market risk and undermines authorities' ability to conduct domestic policy and manage capital flows. A different cost view is that the global status facilitated by offshore currency markets promotes the "exorbitant privilege"—the US dollar is commonly referred to as the global currency that enjoys an exorbitant privilege and imposes costs to other economies.[4]

London, New York, and Tokyo are the renowned offshore currency markets, respectively in Europe, North America, and Asia. Each market offers a rich menu of products denominated in a wide array of foreign currencies. In addition to these main offshore currency centers, there are some known for more regional currencies. For instance, Singapore was known for its role as an offshore currency market for the Malaysian ringgit before 1997 and is still a major offshore currency market for Southeast Asian currencies.

The offshore dollar markets (commonly known as eurodollar markets) constitute the largest segment of the global financial market and greatly facilitate the use of the US dollar in international trade and investment transactions across different time zones and geographic locations. Some argue that the sprawling of offshore US dollar markets is a reflection of the prominence of the US dollar in the international monetary architecture. Nevertheless, it is hard to underestimate the network dollar usage effect generated by these markets that enhances the global status of the dollar.

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[3] For discussions on the conceptual and operational definitions of offshore financial centers, see, e.g., International Monetary Fund (2000) and Zoromé (2007).

[4] Eichengreen (2011) uses "Exorbitant Privilege" as the title of his book that describes the path of the dollar to international prominence and its future prospects.

The evolution of offshore US dollar markets traces the changes in the perceptions of offshore currency markets and currency internationalization. The general perception was quite skeptical in the beginning. Over time, with the expansion of offshore market activity, the sentiment has become quite positive, even though reservations remain.[5]

Could the US experience offer some hints on the nascent offshore RMB markets? Despite the temptation to draw a lesson from history, we note that the US dollar then is quite different from the RMB now. One main difference is that when the eurodollar market emerged in the late 1950s and early 1960s, the US dollar was quite widely accepted as a global reserve currency. The US dollar was essentially in strong demand by both public and private sectors outside the US. Another observation is that in the first few decades of the eurodollar market, the US policies discernibly leaned toward the domestic economy and were not swayed by the possible adverse effects on the rest of the world. A well-known instance is that in 1971, former US Treasury Secretary John Connally told the US allies that “(T)he dollar is our currency, but it is your problem.”

With the background information on the nascent offshore RMB markets and some recent developments in the PRC, we briefly discuss some US policies that took place in the early phase of the eurodollar market (Section 5).

Similar to other financial markets, a well-functioning offshore currency market has to offer both convenience and confidence. Convenience requires a sizable market with depth and breadth. This convenience is enhanced with an established trading and clearance infrastructure, a well-connected transactional network, and a good set of investment and funding alternatives. Confidence relies on the rule of law governing the offshore currency market and the government’s attitudes toward offshore transactions.

The convenience and confidence of an offshore market could be affected by the policy stance of the country that issues the currency being traded. For instance, fund flows associated with offshore transactions at the end have to be cleared in the onshore banking system. By managing and controlling rules and regulations on clearing balances of foreign financial institutions being held with onshore banks, governments could directly and indirectly affect the attractiveness of offshore currency markets.[6]

3. OFFSHORE RENMINBI MARKETS

3.1 Hong Kong, China: Background Information

The offshore RMB market in Hong Kong, China is an archetypical example of the existing offshore RMB trading centers. Both its inception and evolution reflect the PRC’s concerted efforts to shape the development of an offshore RMB market and guide the process of introducing the RMB to the global stage. At the risk of stating the obvious, the reasons of focusing on Hong Kong, China include (i) the offshore RMB market in Hong Kong, China is the first of its kind and has always accounted for the lion’s share of offshore RMB business, and (ii) its special status allows the PRC to design specific policy measures to control and manage the process of RMB

5 Dufey and Giddy (1994), for example, offers a textbook description of the evolution of euro-currency markets. The efforts by some countries to restrict offshore trading of their currencies after the 1997 financial crisis are reported in Ishii, Ötker-Robe, and Cui (2001).

6 The reluctance of the Bundesbank was perceived as a reason of the limited degree of the internationalization of the deutsche mark before the euro era (Franke 1999).

internationalization. Other offshore RMB markets will be briefly discussed at the end of the section.

Hong Kong, China is the PRC's first testing ground for seeking the international use of the RMB. Since its inception in 2004, the offshore RMB market in Hong Kong, China has evolved from a primitive market that was dominated by RMB bank deposits to an increasingly sophisticated RMB trading center that offers a wide range of RMB-denominated products. While other offshore centers including London, Singapore, and Taipei,China are making headway to compete for offshore RMB businesses, Hong Kong, China has maintained its leading position and accounted for about 80% of global offshore RMB payment volumes (SWIFT 2012). In addition to the first-mover advantage, the PRC's policy support plays an important role in Hong Kong, China's accomplishment.[7]

The PRC's choice is closely related to Hong Kong, China's unique economic and political status. Even before the sovereignty change in 1997, Hong Kong, China was a renowned international financial center with well-regarded rule of law practices as well as a world-class financial market infrastructure and had extensive economic ties with the PRC. Post-1997, Hong Kong, China, as a special administrative region of the PRC, maintains its own legal structure and financial system. Specifically, Hong Kong, China has its own currency, the Hong Kong dollar, and imposes no capital controls.

The differences in the legal and financial systems make it relatively straightforward for the PRC to institute specific rules and procedures to regulate cross-border RMB transactions with Hong Kong, China. Notwithstanding that Hong Kong, China is part of its territory, the PRC treats Hong Kong, China as an offshore market in terms of RMB trading. Indeed, market practitioners view the RMB transacted in Hong Kong, China as different from the RMB in the PRC; they coined the trading symbol CNH for RMB traded in Hong Kong, China instead of the usual CNY.[8]

Hong Kong, China commands an advantage over other offshore financial centers. In accordance with its usual gradual reform approach, the PRC has followed a measured strategy to experiment with offshore RMB transactions. Even with a strong preference for seeking the use of the RMB overseas, the PRC is not likely to give up capital controls outright. Thus, in addition to establishing clearing and settlement systems and market liquidity, the authorities have to work out the nitty-gritty of regulatory cooperation. These regulatory cooperation arrangements offer the PRC some leverage to assess the implications of intermediating international transactions in the RMB. For instance, through regulatory cooperation, the PRC could dictate the pace and the means through which offshore RMB capital is remitted back to the domestic market and thus evaluate the effectiveness of its capital control measures and its ability to manage the PRC economy. Since Hong Kong, China is a special administrative region of the PRC, it is relatively pliable. The PRC could dictate both the growth and the evolution of the offshore market via necessary legislation. Thus, on the count of regulatory cooperation, Hong Kong, China has an insurmountable advantage over other international financial centers.

[7] For instance, the policy of developing Hong Kong, China into a prime offshore RMB center was affirmed in the PRC's 12th Five-Year (2011–2015) Plan.

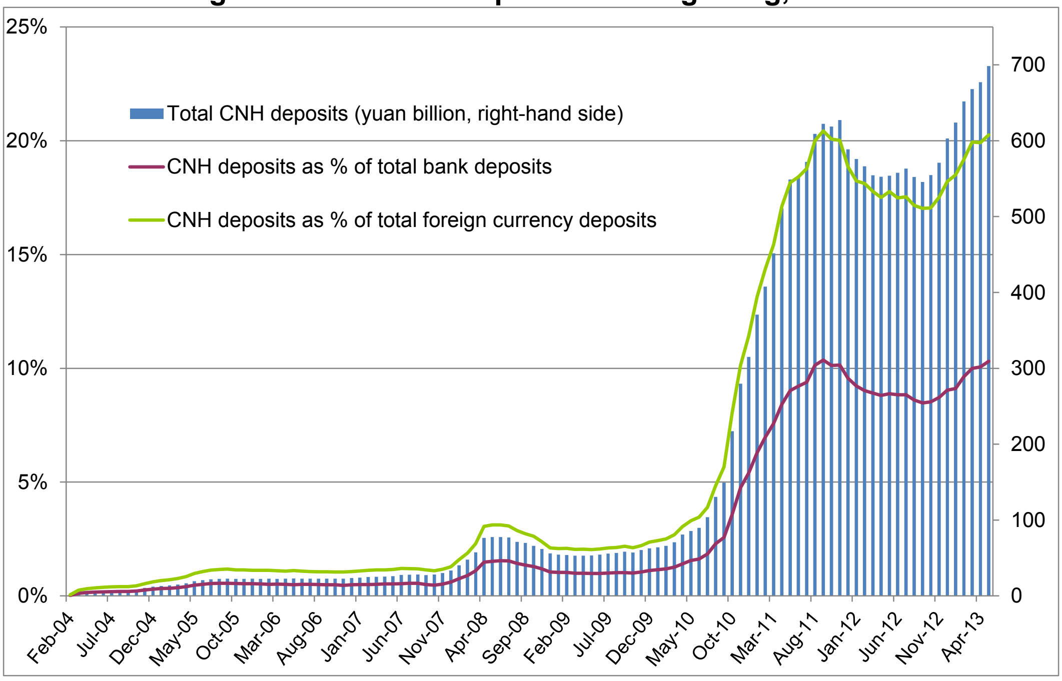
[8] Nevertheless, CNY is still the official International Organization for Standardization currency code in international settlement practice (SWIFT 2011).

3.2 Offshore Renminbi Deposit, Trade Settlement, and Dim Sum Bonds

To set up the stage of launching overseas RMB business activity, the PRC in 2003 appointed the Bank of China (Hong Kong) as the first clearing bank for RMB transactions outside the mainland of the PRC. Hong Kong Interbank Clearing Limited provides the RMB real time gross settlement system, an important infrastructure to support the RMB clearing services in Hong Kong, China and facilitate RMB transactions in other overseas financial centers.[9] With the first-mover advantage and the PRC's policy support, the offshore RMB market in Hong Kong, China has expanded in its size and offering of RMB-denominated products.

Let us consider a few indicators. Figure 1 plots the total offshore RMB (CNH) deposits in Hong Kong, China. The growth pattern of CNH deposits mirrors the anecdotal evidence that the PRC has accelerated its efforts to promote the international use of its currency. The volume of CNH deposits has been on a steep ascent since July 2010—when the PRC expanded the scheme for cross-border RMB trade settlement and the signing of the Supplementary Memorandum of Co-operation between the Hong Kong Monetary Authority and the People's Bank of China on RMB businesses.[10] Between July 2010 and November 2011, CNH deposits grew by 500% from CNY103.4 billion to CNY627.3 billion. The phenomenal growth rate makes the CNH the second most popular foreign currency after the US dollar in the Hong Kong, China market.

Figure 1: Renminbi Deposits in Hong Kong, China



CNH = offshore renminbi.

Source: CEIC Data.

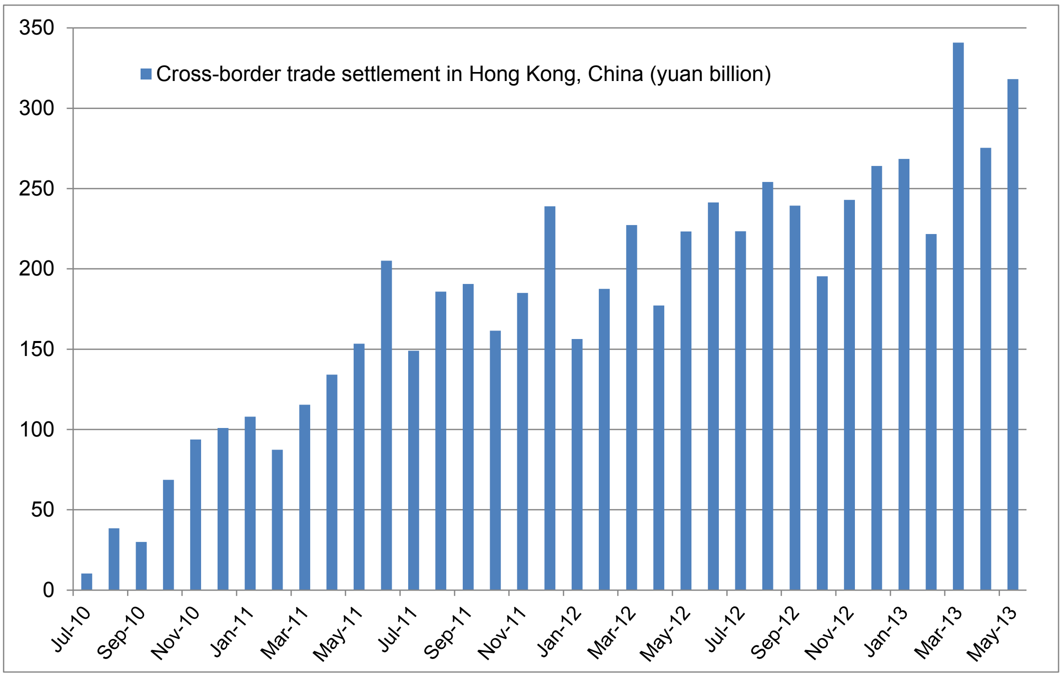
[9] The settlement system operates from 8:30 a.m. to 11:30 p.m. (Hong Kong, China time), which overlaps partly with business hours in London and New York. The Hong Kong Monetary Authority (2013) offers some quick facts about the system including the list of participating banks.

[10] The supplementary memorandum (Hong Kong Monetary Authority 2010) essentially allows a rich menu of RMB trading activities in Hong Kong, China—including spot and forward RMB trading and RMB-linked structural products.

The decline of CNH deposits in the first half of 2012 triggered concern about the prospect of the offshore market. The concern, however, was dismissed in the middle of 2012 when the PRC reaffirmed the role of Hong Kong, China, and the volume of CNH deposits regained its upward trajectory. This instance highlights the PRC's influential role in the development of the offshore RMB market.

International trade settlement is an officially encouraged international use of the RMB. Figure 2 presents the volume of trade settled in RMB conducted via Hong Kong, China. In April 2009, the PRC's State Council approved a pilot scheme for cross-border trade settlement in RMB.[11] The scheme was expanded to cover 20 of the 31 mainland PRC provinces in June 2010 and to cover the entire PRC in August 2011.

Figure 2: Monthly Volume of Cross-Border Trade Settled in Renminbi via Hong Kong, China



Source: Hong Kong Monetary Authority.

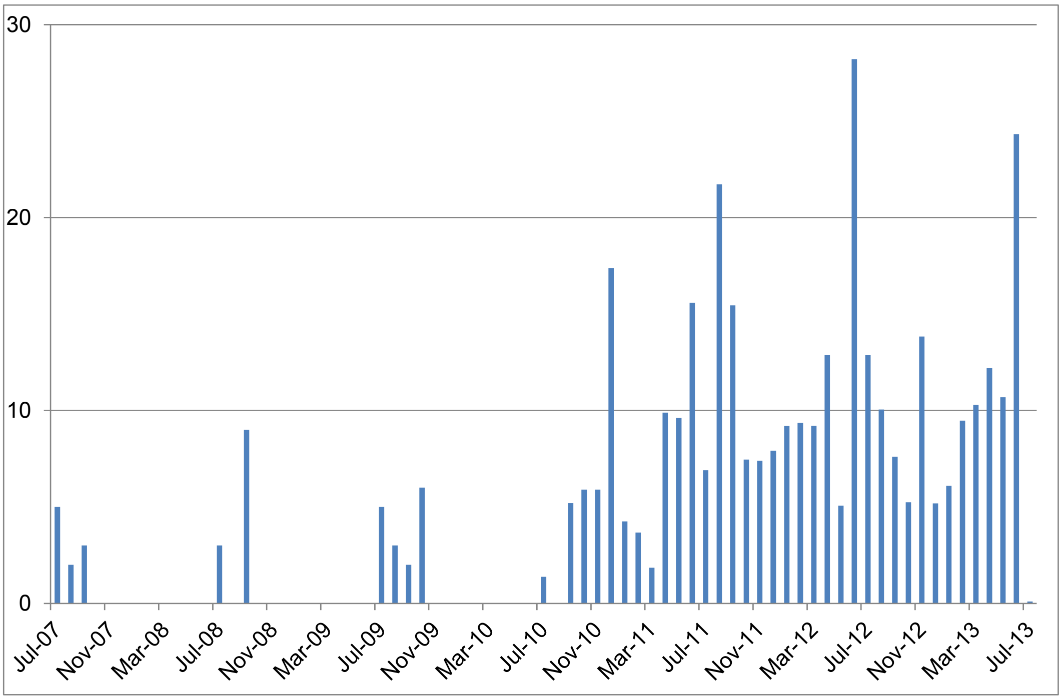
The value of RMB trade settlement has been growing strongly since 2010. The official efforts have paid off quite well: The monthly volume has surged from CNY10 billion in July 2010 to CNY318 billion in May 2013, an increase of almost 31 times in less than 3 years. Even allowing for possible misclassified transactions that are related to arbitrage between onshore and offshore markets via trade invoicing, the growth of the volume of trade settled in RMB is quite phenomenal.

Another concerted effort is to establish an offshore RMB bond market in Hong Kong, China. The first issuance of dim sum bonds, RMB-denominated bonds issued in Hong Kong, China, by the China Development Bank in 2007 started a new chapter in the history of the offshore RMB market. The monthly issuances of dim sum bonds are

[11] The use of the RMB to settle cross-border trade could be traced back to at least 2003. See, e.g., the directives issued by the PRC's State Administration of Foreign Exchange (2003a, 2003b) on using the RMB in settling trade. Before 2009, RMB trade settlement mainly occurred for trade taking place along the PRC's borders with, e.g., Cambodia, Mongolia, the Russian Federation, and Viet Nam. Data on these cross-border trade settlements are quite scant. The discussion in this paper thus focuses only on the post-2009 era.

plotted in Figure 3. After the first few years, there has been a steady flow of offers to the dim sum bond market. The typical monthly issuance volume is below CNY10 billion.

Figure 3: Monthly Issuance of Dim Sum Bonds (CNY billion)



Source: Bloomberg.

Among all the issuers, the PRC's Ministry of Finance plays a special role. Every year since 2009, the Ministry of Finance has issued its RMB sovereign bonds in Hong Kong, China. The sizes of issuances are usually large and range from the CNY6 billion offer in 2009 to the CNY23 billion offer in 2013.[12] Different from other dim sum bond issuances, the Ministry of Finance sovereign bonds cover long tenors up to a maturity of 30 years. The issuance of long-term RMB-denominated bonds is seen as an effort to set up an offshore market yield curve, which is essential for the operation of a full-fledged offshore RMB bond market.

A main difference between dim sum bonds and onshore RMB bonds is that they are governed by different legal systems. The dim sum bond covenants are typically covered by the laws of Hong Kong, China, and not those in the mainland of the PRC. In general, the legal system in Hong Kong, China is being considered as an internationally recognized legal framework. Thus, the dim sum bond market is attractive to individual and sovereign investors who are concerned about, for example, possible covenant violations and insolvency proceedings. Furthermore, trading in the dim sum bond market is not subject to the regulations and disclosure requirements in the onshore market.

[12] The 2013 issuance was offered in two slots: one of CNY13 billion and the other of CNY10 billion.

3.3 An Interim Assessment

3.3.1 General Development

Most of the actions in the offshore RMB market have taken place after the recent global financial crisis. Since then, a variety of financial products denominated in RMB were introduced in Hong Kong, China. These RMB-denominated products are available in retail and corporate banking, capital and currency markets, and the insurance sector.[13] Some examples are RMB-denominated equities and exchange-traded funds, RMB-denominated certificates of deposit, Renminbi Kilobar Gold, foreign exchange options, futures and related RMB-linked structural products, and insurance plans and products.

There is no denying that the nascent offshore RMB market has been progressively expanding its size and product variety. In general, the offshore market provides a physical platform for the PRC to assess the implications of using the RMB to intermediate international transactions and for the rest of the world to become familiar with the RMB via real-life business activities.

The PRC's domestic finance sector is relatively underdeveloped and has limited experience with modern financial transactions. The PRC authorities, via the offshore market activity, could assess the responses of domestic and overseas participants on RMB exchange rate flexibility and convertibility, and their subsequent implications for their ability to manage the local economy. Similarly, PRC corporations and financial institutions could gain practical experience conducting international business using the RMB in a legal environment that is recognized by international participants but that is different from the one in the PRC, and recognizing trading partners' currency concerns. They could also experiment with various RMB-denominated products in offshore markets to manage their funding and investment needs.

Anecdotal evidence based on the conferences, seminars, and workshops offered by financial institutions, professional bodies, and commercial entities suggests that corporations and investors domiciled outside the PRC have tremendous interest in the offshore RMB markets. For these overseas participants, sourcing and investing in the RMB is an unchartered territory. While it could be costly, if not impossible, for them to access the local RMB market, the offshore RMB market in Hong Kong, China presents an attractive alternative. Without capital controls, Hong Kong, China allows individuals to move funds in and out of the offshore market to assess the costs and benefits of working with the RMB.

For instance, for a corporation to adopt the RMB as a settlement currency, it has to set up the corresponding internal and external arrangements, including guidelines for cash management, exchange rate risk management, fund transfers, and banking facilities. While the common principles are assumed to be common knowledge, individual corporations have their own idiosyncratic practices that are implemented and evolved according to, for example, management philosophy and local regulations. The offshore RMB market offers a testing ground for them to work out and fine-tune the practical aspects of including the RMB in their menus of operating currencies. Similarly, overseas investors could learn the trading and settlement details of moving RMB funds in and out of the market.

These experiences, in principle, help the domestic and foreign corporations and investors set up similar operations in their operations in the PRC.

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[13] See, for example, the Hong Kong Monetary Authority (2013) for a list of available RMB-denominated products.

3.3.2 Some Specific Issues

Despite the healthy development in the last few years, the offshore RMB market is quite far from a full-fledged offshore market such as the eurodollar market. For instance, the offshore RMB market still lacks some basic features, including credit ratings of dim sum bonds, which have expanded quite rapidly but at the cost of diluting the issuer's quality. The presence of low-quality issuers raises the concern about dim sum bonds without explicit clauses in their covenants to protect investors. Naturally, the availability of objective credit ratings and improved investor protection will nurture the dynamic growth of the dim sum bond market.

Only recently in June 2013 was CNH Hong Kong Interbank Offered Rate (HIBOR) fixing offered by the Treasury Markets Association in Hong Kong, China. The fixing covers tenors from overnight to 1 year. Though its overall effect still has to be seen, the CNH HIBOR fixing facilitates the pricing of offshore RMB-denominated loans and related structural products for risk management.

Despite its rapid growth, the scale of the offshore RMB market is still small. For instance, even though the volume of CNH deposits has jumped to CNY698.5 billion as of May 2013, it is less than 1% of the PRC's domestic deposit balance of CNY99.3 trillion in the same period. Since the other offshore RMB markets are much smaller than the one in Hong Kong, China, the total offshore RMB deposits are likely to be less than 2% of domestic deposits.[14]

The PRC's extensive trade network justifies its policy of introducing the RMB to the global stage via the trade settlement channel. Complementing the official stance, it has been reported that PRC corporations offer price concessions to encourage their overseas trading partners to conduct their import and export transactions in RMB. Since the scheme was first introduced in 2009, the value of cross-border PRC trade settled in RMB has increased from a minuscule amount to the aggregate monthly volume of CNY364.3 billion as of May 2013, which represents 16.9% of the PRC's aggregate trade volume in the same period. This is quite an impressive development.

The current percentage of trade settled in RMB, however, is far less than the one-third proportion predicted by Chen and Peng (2007). Furthermore, it is noted that Japan settles about 40% of its trade in the yen (Goldberg and Tille 2008) and the eurozone has more than one-half of its international trade invoiced in its own currency even in the midst of the sovereign debt crisis (European Central Bank 2013). Of course, whether or not the one-third stipulation is achievable depends on economic and political developments both in the PRC and the global economy.

In passing, we note the role of a vehicle currency as an important attribute of an international currency. Even though the PRC has made impressive strides in using RMB to settle its trade with the rest of the world, the RMB has played a limited role as a vehicle currency. Additional efforts have to be made to enhance its vehicle currency function.

There are a few observations pertaining to the dim sum bond market. First, both the monthly issuance value and outstanding volume of the dim sum bond market are small compared with the bond market in the PRC—the relative size is not surprising given the short history of the offshore market.

However, it is less encouraging to observe that, despite the increase in market size, dim sum bond issuance is dominated by the PRC's Ministry of Finance and policy

[14] The comparable RMB deposit figures in, e.g., Taipei,China and London, are estimated to be less than CNY70 billion and CNY6 billion, respectively.

banks. The monthly issuance is typically below the CNY10 billion mark in the absence of these issuers. The PRC institutions and their affiliates in Hong Kong, China together are estimated to account for well over one-half of the value of outstanding offshore bonds (Cheung and Hui 2013). Despite the policy intention to promote offshore market activities and the lower RMB funding cost in the offshore market compared to the onshore market, not all the PRC corporations are allowed to issue dim sum bonds. PRC corporations have to obtain official approvals and financial guarantors before they can issue dim sum bonds in Hong Kong, China. The procedures result in reducing the default risk and managing the inflow of offshore RMB capital.

The lack of active nonresident issuers undermines the international nature of the dim sum bond market and limits its funding and investment opportunities. The dominance of PRC issuers reflects the PRC's policy stances. For instance, overseas issuers have limited ways to deploy the RMB capital raised via dim sum bond issuance. Investment opportunities in offshore markets are constrained by the limited investment products denominated in the RMB and those in the onshore market are hampered by administrative regulations for foreign issuers to remit offshore RMB capital back to the PRC.

In addition to the international characteristic of the currency, the presence of nonresidents has implications for the benefit of promoting the use of the RMB overseas. With its trade surplus and capital inflows, the PRC's external assets are mostly in foreign currencies and predominantly in US dollars. On the other hand, most of its international liabilities are in RMB. Thus, by allowing nonresidents to borrow in RMB, the PRC increases its RMB-denominated claims and shares the exchange rate risk arising from its dollar-biased international assets and liability position with the rest of the world (Cheung, Ma, and McCauley 2011). The current composition of the dim sum bond issuers does not offer much risk-sharing benefit to the PRC.

3.4 Other Contenders

Given its enormous potential, the offshore RMB business has attracted considerable attention from financial centers around the world. These cities are eager to explore the possibility of setting up the infrastructure to compete for a share of the global offshore RMB business. London, Singapore, and Taipei,China are considered as serious contenders. Others including Dubai, Frankfurt, Luxembourg, San Francisco, and Tokyo are reportedly preparing themselves, at different stages, for a slice of the global RMB market.

Despite all the hype on building up offshore RMB businesses in these cities, Hong Kong, China so far has maintained its competitive edge and accounts for over 80% of overseas RMB payment flows (SWIFT 2012). Essentially, the prominence of Hong Kong, China reflects the policy-driven nature of the offshore RMB market. Without the PRC's endorsement and support, it is hard for other financial centers to expand their RMB activities. The offshore RMB settlement and clearing infrastructure, for instance, was only available to Hong Kong, China before 2013.[15] While Taipei,China and Singapore had their own authorized RMB clearing banks by the first half of 2013,[16]

[15] Hong Kong, China also benefits from the swap arrangement it established with the PRC. The CNY400 billion swap line is the largest of the currency swap lines the PRC has arranged so far and provides the needed RMB liquidity to operate and expand the offshore market smoothly.

[16] The Bank of China and the Industrial and Commercial Bank of China are, respectively, the local RMB clearing banks in Taipei,China (February 2013) and Singapore (May 2013). Macao, China, a special administrative region of the PRC, also has the Bank of China as its RMB clearing bank.

London relies on Hong Kong, China and leverages upon its settlement and clearing facility.

Currently, Hong Kong, China is the major player. Nevertheless, the offshore RMB business is likely to take root gradually in other financial centers. The presence of more established offshore RMB centers across different geographic locations and time zones will increase the global RMB liquidity and business opportunities—and these developments help to increase the degree of the RMB's international acceptance. Thus, it is in the PRC's interest to support additional RMB trading markets and work with other financial centers to develop offshore RMB businesses.

Taipei,China and Singapore, for example, have seen their offshore RMB activities grow quickly after their authorized local RMB clearing services were launched in early 2013. The offshore business in Taipei,China is underpinned by its special political relationship and economic ties with the mainland of the PRC. On the other hand, Singapore, as a major financial hub in Southeast Asia, would operate an active offshore RMB market by leveraging upon its well-established financial market infrastructure and links with neighboring countries. These two economies, both with a local RMB clearing bank, are in the position to compete for a spot in the global offshore RMB market.

It is hard to underestimate the potential of London as an offshore RMB market. As a premium international financial center, London could provide critical RMB business services in the western hemisphere and beyond. Even without a local RMB clearing bank, London signed a 3-year swap agreement of CNY200 billion with the PRC in June 2013. The swap line is the first that the PRC signed with a Group of Seven country. The symbolic meaning for London's role in offshore RMB business may be more than the RMB liquidity available through the swap line. London's potential to be a significant hub of the global RMB business is enhanced with the promise of the renminbi qualified foreign institutional investor (RQFII) quota of CNY80 billion announced in October 2013. London's current status is attested by the SWIFT statistics, which show that, excluding the PRC and Hong Kong, China, the United Kingdom accounts for over 50% of RMB foreign exchange transactions.[17]

Conceivably, London's good relationship with Hong Kong, China plays down the possible drawbacks of using Hong Kong, China's RMB clearing facility to develop its offshore RMB business.

New York, another important international financial center, is mysteriously missing from most discussions surrounding offshore RMB business. Even though the PRC launched trading of its currency in the US in January 2011,[18] New York seldom publicly expresses its interest in establishing an offshore RMB market. Whether it is due to political considerations or regulatory concerns, New York, compared for example with London, is seen to be not enthusiastic or not aggressive in developing RMB businesses. In fact, New York appears to be behind in the game of securing offshore RMB business.[19] For instance, the US accounted for 14% in 2012 and 13% in 2013 (up to September) of the offshore RMB foreign exchange transactions outside Hong Kong,

[17] The United Kingdom accounted for 54% in 2012 and 62% in 2013 (up to September). See SWIFT (2013).

[18] The scope of trading is restricted; the purchase of RMB for an individual US customer is limited to the equivalent of $4,000 a day (Wei 2011). However, there is no limit on converting RMB back into dollars. There are also no conversion limits on businesses that are engaged in international trading.

[19] In February, 2013, San Francisco, the third largest financial center in the US, was reported to be planning to be a center for offshore RMB trading (Ross 2013).

China and the PRC. These numbers are much smaller than the corresponding ones of the United Kingdom (SWIFT 2013).

Evidently, the PRC has been strategically guided the development of the offshore RMB market in Hong Kong, China. With its efficient financial infrastructure, relative pliability and track record on implementing the offshore RMB strategies, Hong Kong, China is likely to maintain a considerable lead in the global offshore RMB business in the near future. Assuming that the currency is increasingly used overseas and people are becoming familiar with the offshore market, the acceptance of the RMB will improve and additional demands will be created. When the RMB realizes its potential as an international currency, it could support the existence of multiple active offshore RMB markets. When the overall offshore RMB business grows, it will benefit Hong Kong, China and other financial centers. In the meanwhile, Hong Kong, China is leading the pack in the offshore RMB business, followed by London, Singapore, and Taipei,China —and other financial centers are vying for a piece of the action.

4. DEVELOPMENTS WITHIN THE PEOPLE'S REPUBLIC OF CHINA

Citing the extreme impediments and controls in the onshore market, skeptics are concerned about the effectiveness of the PRC's outsourcing approach to internationalize the RMB. It is fair to assert that if the PRC maintains its status quo and does not implement complementary changes in the domestic market, the offshore experiences would have only limited implications for the overall acceptance by the international community.

Anecdotal evidence, however, indicates that the PRC has been progressing along its path of reform. While opinions could differ on whether the pace of reform is too slow or appropriate, there is no sign that the process has stopped. For instance, since the beginning of 2013, the PRC has introduced policies to simplify regulatory requirements on cross-border RMB payments for large international corporations, and on the deployment of onshore and offshore funds by foreign firms. These changes help to improve the efficiency of the domestic system and thus complement the effort of promoting the overseas use of the currency. Also, on 19 July 2013, the People's Bank of China announced the removal of controls on lending rates, which is the latest policy move toward interest rate liberalization.

In the next subsection, we briefly discuss capital controls. The rest of the section is then devoted to discussing two noticeable developments in the arena of policy reform.

4.1 Capital Controls

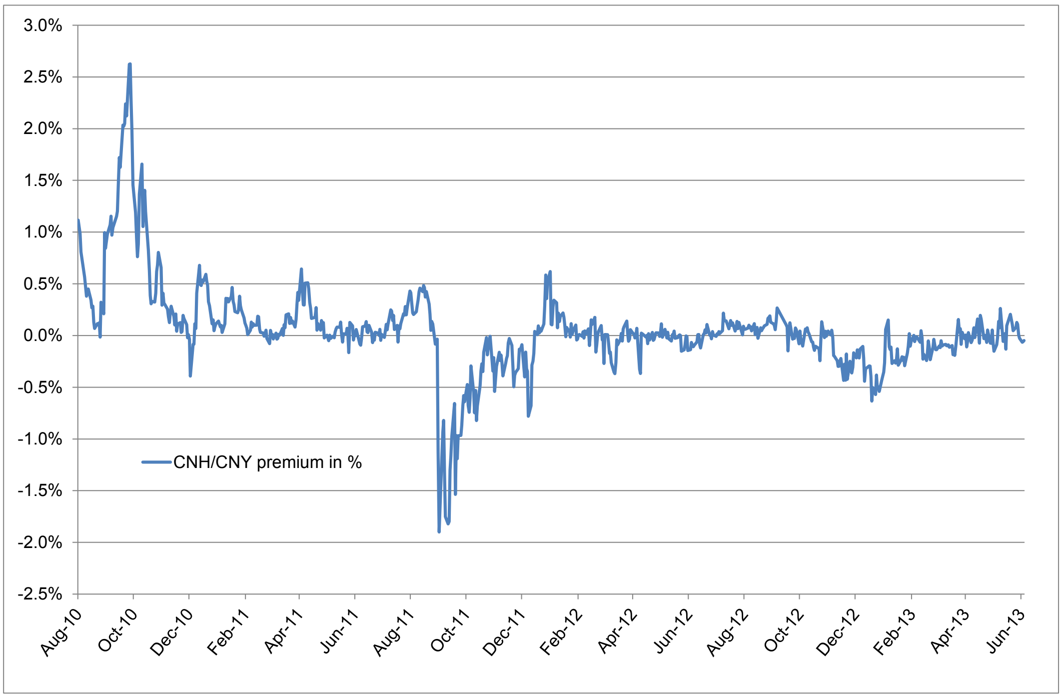
When the PRC switched to an aggressive mode to promote the RMB, there was a serious debate on the necessity of removing capital controls before internationalizing the currency. Despite the PRC relaxing its regulatory policy over time, a strong view is that it is premature to push for the international use of the RMB before liberalizing local financial markets. Some, however, acutely point out that the sterling pound and the US dollar acquired their prime international currency status in an era when capital controls were the norm. For instance, in the early period of the eurodollar market, the US imposed restrictions on the inflow of the dollar from overseas. Indeed, the US only removed the deposit interest rate ceilings, with the exception of the demand deposit rate, in the 1980s.[20] These experiences undermine the causal link between capital controls and currency internationalization.

Nevertheless, the implication of capital controls for the overseas use of the RMB could be stronger than the one, for example, in the 1950s. To gain a share in the international market, the RMB has to compete with the US and other international currencies that are subject to few capital controls. Will people select a currency subject to capital controls or not?

Against the odd, the offshore RMB market in Hong Kong, China has developed quite quickly in the last few years. The development has also attracted the interest of a few other financial centers to join the offshore RMB venture. As noted above, the arrangement for foreign financial institutions to clear cross-border trade and investment transactions through the appointed local RMB clearing banks makes the offshore business possible. The PRC, by offering the means to foreign financial institutions to manage their RMB clearing balances, effectively creates a form of convertibility for designated cross-border RMB transactions. The arrangement is similar in spirit to the one adopted by the US before convertible capital account era (He and McCauley 2013).

What is the implication of the nascent offshore RMB market for the PRC's capital controls? Ma and McCauley (2008) and Cheung and Herrala (2014), for example, show that the PRC's capital controls have not been watertight but remain substantially binding. The evidence based on offshore RMB (CNH) and onshore RMB (CNY) exchange rates give a different impression. The percentages of daily CNH–CNY premiums are plotted in Figure 4.

Figure 4: Offshore/Onshore Renminbi Premiums



CNH = offshore renminbi, CNY = onshore renminbi.

Source: Bloomberg.

[20] These interest rate ceilings were eliminated between 1981 and 1986. The payment of interest on demand deposits was allowed (but not required) in 2011.

If we use the premium of CNH over CNY to gauge the market price of capital controls, the price appears less volatile and converging. When the CNH was introduced in late 2010, it enjoyed a premium that reflected the market's preference of the RMB in Hong Kong, China where no capital controls are imposed. The negative premium observed in September 2011 was attributed to a policy crackdown on mis-invoicing of CNH transactions and to a decline in risk appetite due to heightened market volatility in that period. Since then, the premium has fluctuated mainly in the range of –0.5% to 0.5%. The circumstantial evidence thus suggests that (i) the PRC's capital controls are becoming less effective, (ii) the market is placing a smaller value on convertibility of the CNH market over time, (iii) the market anticipates, over time, the PRC's ongoing policy reform to reduce the cost of capital controls on business, or (iv) the CNH exchange rate follows the CNY exchange rate because the trading volume of the latter is much larger than that of the former.[21]

4.2 A Domestic Offshore Market

On 27 June 2012, the PRC unveiled a bold economic reform initiative to create a special economic zone within the first special economic zone Shenzhen in the PRC. In essence, the central government approved the plan to develop Qianhai, a port district of Shenzhen, into a modern service industry cooperation zone that enjoys pilot policy preferences beyond those available to Shenzhen.[22] Most commentators lauded the initiative as a confirmation of the PRC's commitment to liberalize its capital account and to boost the international use of the RMB.

To be sure, the Qianhai area is not set for completion until 2020, and the reform initiative goes beyond the finance sector.[23] Nonetheless, the hype surrounds the provisions related to offshore RMB business. One key theme of the experimental zone is that offshore RMB capital could be sent back to Qianhai. Possible arrangements include that eligible enterprises and banks in Qianhai could borrow RMB loans from banks in Hong Kong, China; issue dim sum bonds; and extend offshore RMB loans. These arrangements will convert Qianhai into an offshore RMB center within the PRC. It should be noted that the exact policies and terms governing these cross-border RMB-based transactions are still in the process of being unfolded.

At first glance, the creation of a hub to recycle offshore RMB back to the PRC will benefit the offshore RMB market in Hong Kong, China by enriching its investment opportunities. However, there may be some unintended consequences. Currently, there is a legal firewall between the offshore and onshore markets. One concern is the leakage of offshore RMB capital back into the domestic PRC economy. If offshore RMB could be loaned to enterprises in Qianhai, then should the PRC institute some regulatory oversight of Qianhai to preserve the existing capital controls for the rest of the country?

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[21] According to BIS (2013), Hong Kong, China accounted for 16% of the total global RMB foreign exchange trading and the onshore market accounted for 59% of the trading volume.

[22] See the "Official Reply of the State Council on Policies Concerning the Development and Opening of Qianhai Shenzhen–Hong Kong Modern Service Cooperation Zone of Shenzhen" released by the State Council. The approved plan for Qianhai is based on the one outlined in the document "Overall Development Plan for Qianhai Shenzhen–Hong Kong Modern Service Industry Cooperation Area" approved in August 2010.

[23] The modern service industries covered by the development plan include the financial and securities industries, legal and professional services, education and medical services, and telecommunication services. Preferential tax incentives will be offered to qualified enterprises and workers.

It may not be a critical matter in the beginning as the initial pilot loans were relatively small and mostly for financing the development and construction of the Qianhai district. The leakage effect, however, will aggravate quickly once the business borrowing and lending activities pick up near and after the completion of the Qianhai project in 2020. Unless the PRC eradicates its capital control policy and modernizes its finance sector by 2015 or by 2020—the target dates that are sporadically mentioned in the media—one has to consider the challenges of reining in the spillovers to the domestic economy from Qianhai.

In principle, the influence of offshore transactions on the domestic offshore market could be contained. A good example is the US international banking facilities (IBFs) set up in December 1981. By requiring banks to keep different books for onshore and offshore transactions and the related regulations, IBFs create an offshore market setting that is physically located within the US (Dufey and Giddy, 1994; He and McCauley, 2013). A well-functioning domestic offshore market such as the IBFs could create a symbiotic relationship between onshore and offshore markets. Similarly, Japan established the Japan Offshore Market in Tokyo in December 1985 to accommodate offshore yen transactions within Japan.

In passing, it is noted that policy measures designed to establish an onshore offshore-market may not have the designated effects. For instance, the Japan Offshore Market was established in response to foreign pressure and did not contribute significantly to the liberalization of Japan's capital account and the international use of the yen (Osugi 1990; Takagi 2011). Indeed, an onshore offshore-market could backfire. Krongkaew (1999), for instance, asserted that the Bangkok International Banking Facility established in 1993 which allowed enormous capital inflows is one of the causes of the 1997 crisis in Thailand.

The real issue is of course the cost for the PRC to implement a set of operationally efficient regulations to insulate the domestic sector from possible adverse impacts of offshore RMB capital. Some related issues are the implications of the presence of segregated onshore and offshore accounts for tax, regulatory, and risk management policies. Given the PRC's relatively unsophisticated financial system, the administrative cost of setting up effective barriers to contain the spillovers from an offshore market that is physically located within the country is quite high.

The financial innovation of recycling offshore RMB capital could give a short-term boost to the offshore RMB market in Hong Kong, China, but at the expense of impeding the long-term growth potential of the international use of the RMB. Cross-border trade settlement is a main component of the current extraterritorial use of the RMB. The global function of the RMB, however, goes beyond the settlement of the PRC's exports and imports.

Along the path to become an international currency, the RMB should evolve to be a vehicle currency that facilitates transactions among nonresidents. Consider the prime global currency, the US dollar: A large proportion of international transactions denominated in the US dollar do not involve US entities. Currently, the liquidity in the offshore RMB market is still quite low on the international scale. If the RMB recycle program works too well, it will constrain the offshore RMB liquidity available to nonresidents and thus stifle the use of the RMB as a vehicle currency. This will, in turn, inhibit the growth of the offshore RMB market. Thus, in the absence of a progressive scheme to provide RMB to nonresidents, a RMB recycle program may work against the objective of promoting the overseas use of the currency.

4.3 The Shanghai Free Trade Zone

The anointment of Qianhai as the designated hub connecting the offshore market in Hong Kong, China and the domestic market raises the question of the role of Shanghai in promoting the overseas use of the RMB. For a short period, it is conceivable that Shanghai will stay on its course to become a global center for onshore RMB business, but not a base of the domestic offshore RMB activity. However, the approval of the establishment of the Shanghai Free Trade Zone by the State Council in July 2013 has reasserted the role of Shanghai in the PRC's reform agenda. The zone was officially inaugurated on 29 September 2013.

Similar to the Qianhai initiative, the official plan of the Shanghai Free Trade Zone encompasses reform measures in several service industries.[24] The official document also stated that the Shanghai Free Trade Zone, under the presumption of risk controllability, could be the testing ground of capital account RMB convertibility, market-determined interest rates, and cross-border RMB transactions. There are considerable overlaps between financial reform measures of the Qianhai project and the Shanghai Free Trade Zone.

At the time of writing, these reform measures are mostly casted in general terms and the specifics are vague. The shortness on specifics makes it difficult to assess the actual impacts of these measures on exchange rate flexibility, capital account convertibility, and interest rate liberalization. Nevertheless, the administrative challenges of implementing financial reforms on a restricted domestic physical area and preventing the spillovers to the domestic financial market discussed in Subsection 4.2 are relevant to both cases. Specifically, a serious challenge is how to rein in the effect of offshore RMB capital inflows while retaining an effective grip on capital controls in the rest of the PRC.

4.4 Some Implications

Both the Qianhai initiative and the Shanghai Free Trade Zone reassure the global community that, albeit in its usual gradual style, the PRC is on the course of opening up its economy in general—and deepening its financial reform in particular.

The announcements of the Qianhai project and the Shanghai Free Trade Zone have triggered discussions on the future of the offshore RMB market in Hong Kong, China. One view is that, under the presumption that the two reform experiments conducted in the limited physical areas would trigger and speed up financial reforms at the national level, Hong Kong, China will be marginalized and lose out in the process. While the construction of the Qianhai region will be completed in 2020, the Shanghai Free Trade Zone is officially in operation since September 2013. Will Shanghai—the PRC's commercial heavyweight and designated international financial market—with the free trade zone provision undermine its archetypical competitor, Hong Kong, China?

The (implicit) rivalry and competition between Hong Kong, China and, for example, Shanghai depend crucially on how fast the PRC could revamp its financial market regulations, tax policies, and the related governance practices. The history of international finance shows that the process of capital account liberalization is usually laden with financial and economic crises. Indeed, the PRC is quite concerned about the

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[24] These include financial services, shipping services, trade-related services, professional services, cultural services, and social services. See http://www.shftz.gov.cn/WebViewPublic/item_page.aspx?newsid=635158957941988294&coltype=8 (in Chinese).

adverse effects of hot money flows. Such a concern is reinforced by a recent study that shows the capital account liberalization in the PRC may trigger net portfolio outflows (Bayoumi and Ohnsorge 2013).Thus, in the process of opening up and modernization, the PRC has to navigate carefully through the minefield of capital account liberalization.

Against this backdrop, it is expected that the PRC is likely to follow its typical gradual approach in reforming the domestic finance sector. Hong Kong, China is likely to enjoy its comparative advantages in brokering financial transactions for the time being. The PRC, in promoting onshore financial centers, could diversify its financial business within the country.

As noted earlier, while Hong Kong, China has been designated as the premier offshore RMB market, it has to compete and, more importantly, cooperate with other overseas international finance centers and onshore financial centers to promote the international use of the RMB. With its first-mover advantages in offshore businesses and settlement facilities, Hong Kong, China is well positioned to meet the challenge of increased competition in the foreseeable future. A more relevant question is: what is Hong Kong, China's role when the PRC has removed capital controls and instituted capital account convertibility?

Barring unexpected developments, Hong Kong, China with its established financial market infrastructure, well-regarded legal system, and extensive international network would maintain its role as a renowned international finance center. When the PRC has achieved capital account convertibility and has realized the potential of the RMB as a global currency that is commensurate with its economic and political strengths, the global offshore RMB market will be much larger than its existing size. When the pie grows bigger, Hong Kong, China will benefit too. Looking into the future, Hong Kong, China is likely to enjoy a healthy volume of offshore RMB activity though not necessarily its current large share of the offshore market.

Considering the experiences of the offshore US dollar markets, for example, it is not unreasonable to anticipate that the growing global RMB activity will support multiple financial centers conducting offshore RMB businesses. Even within the PRC, given its geographic diversity and economic size, it could support more than one local financial center.

Apart from the rivalry viewpoint, a holistic approach is to interpret the PRC's efforts in establishing the offshore RMB market in Hong Kong, China and implementing the Qianhai and the Shanghai Free Trade Zone initiatives as integral to its overall financial development strategy. As unfolded in the last few years, Hong Kong, China's experiences have been used to develop offshore RMB businesses in other financial centers overseas and to guide the two domestic initiatives. According to official documents, both domestic initiatives are initially confined to the designated geographic regions. However, the successful financial reform practice will be transplanted to other parts of the country so as to broaden the financial account liberalization policy to the national level. That is, the PRC is following a two-pronged approach that involves both offshore and onshore markets to promote the international use of the RMB and to implement its financial development policy—an interpretation that is in line with the PRC's usual gradual and trial-and-error approach.

5. A FACILITATOR

5.1 Canonical Economic Factors

A fair assessment of the role of offshore RMB markets has to consider possible factors that affect the global status of a currency. The factors considered in the literature include (i) the size of the economy and the trade sector, (ii) the size and quality of the financial market, (iii) capital account openness, and (iv) the economic and political stability. These factors are largely affected by domestic economic policies and not directly influenced by an offshore market policy.

Undeniably, the PRC fares quite well on factors (i) and (iv) but not on capital account openness and financial markets. Capital account openness, indeed, is a hotly debated concern. As noted in Subsection 4.1, complete capital account openness is not a necessary precondition of the international use of the RMB. As attested by the extant offshore and cross-border RMB activities, the PRC's policy of allowing foreign financial institutions to manage their RMB balances that are (directly or indirectly) held with domestic banking system presents a form of convertibility that facilitates the international use of the RMB. Of course, a full-fledged global RMB requires the support of an open capital account.

Despite the usual hyperbolic rhetoric on how far and how fast the PRC could liberalize its capital account and transform its finance sector, the PRC has to take the time to put in place the hardware and, more importantly, the software that are required to establish and maintain a robust finance sector and the related regulatory framework. Evidently, the PRC is continuing with financial development policy. The modernization of the finance sector, given its close links with other segments of the economy, requires accompanying policy changes in other sectors and even in politics. In view of its usual incremental and gradualist reform style, there are good reasons to expect that it will take the PRC a long time to implement changes that lead to a deep and efficient finance sector. As such, a full-fledged international RMB will be a distant goal.

Subject to the level that is allowed by the PRC's policy, the ultimate overseas demand is determined by the desirability of the RMB as a global currency perceived by nonresidents. One could say that an offshore market policy facilitates a currency to attain its level of acceptance overseas warranted by its economic fundamentals but not beyond that.

5.2 Clues from the Eurodollar?

Could the advances in the offshore RMB market induce changes to the domestic markets, including policies of capital controls and thus force the progress of the RMB internationalization process? Did the US responses to the evolution of the eurodollar market offer some insights?

As noted in Section 2, the US dollar was a reserve currency when the eurodollar market emerged in London during the late 1950s. The reserve currency status is an important organic growth factor of the eurodollar market. Furthermore, both the US economic and military reaches help to further spread the use of the US dollar around the world. The RMB, on the other hand, is still in the early stage of being a reserve currency and a global currency. The difference in the status of these two currencies makes it quite difficult to directly apply the US dollar experience to the RMB.

Indeed, in the early phase of the eurodollar market, the US policy stance was to protect the onshore market from the offshore market. The commonly mentioned US policy responses include the Interest Equalization Tax (1963), the Voluntary Foreign Credit Restraint Program (1964), and Regulation D (1969). Essentially, the Interest Equalization Tax narrowed the US dollar funding costs of domestic and offshore bond issuers. The Voluntary Program limited the onshore banks' lending to nonresidents. The 1969 Regulation D rule imposed marginal reserve requirements on US bank borrowings from the offshore dollar market.[25]

Apparently, the scale of the eurodollar activity had a material impact on business conditions in the US. Consequently, the US devised these policy measures to isolate and divert the adverse effects of the offshore US capital. That is, the US at that time was imposing implicit and explicit restrictions on cross-border capital movement. Interestingly, it is commonly perceived that these restrictions by limiting the dollar flow actually fostered the growth of the eurodollar market.

As these measures were being phased out in the late 1970s and the 1980s, the US IBFs were introduced in 1981 to create a level playing field for onshore domestic financial institutional to compete directly with ones offshore. Arguably, the motivation behind the IBFs is different from that behind the PRC's Qianhai initiative, which is dubbed a Chinese version of an onshore offshore market. The former aims at equalizing the competition between onshore and offshore banks while the latter focuses on financial reforms.

These developments are quite different from those observed from the recently developed offshore RMB market and the PRC's policy initiatives on promoting the use of the RMB overseas. The US dollar then and the RMB now are facing different domestic and overseas conditions. The PRC now is experimenting with financial (currency) internationalization, while the US then tried to rein in the offshore market influences on its domestic economy. In addition to the difference in the global status of the two currencies, the differences in the scope and scale of the offshore dollar and RMB markets contribute to the dissimilar responses.

Over the last few years, the PRC made some concerted effort to push the RMB to the global stage, and to convince the rest of the world to adopt its currency for international transactions, albeit in a controlled manner. Despite its rapid growth, the offshore RMB market is still quite small compared with the onshore market (Section 3). The large difference in market size constrains the ability of the offshore market to affect the development of the onshore market. Besides the market size element, the limited feedback from the offshore market is ascribed to the PRC's tight grip on its own finance sector and the offshore market. There is no indication that the PRC changes its reform policies under the pressures of offshore RMB activities including cross-border arbitrage.

5.3 Noneconomic Factors

Notwithstanding official policies and good intentions, the economic quality of the currency itself is not the sole factor determining the acceptance of the RMB in the global market. Beyond some fundamental structural changes in its finance sector, the PRC has to convince other countries to conduct international trade and financial transactions in its currency. The persuasion, as attested by Japan's attempt to internationalize its currency in the late 20th century (Japanese Ministry of Finance

[25] The reserve requirement was increased from 10% to 20% in November 1970.

2003; Takagi 2011), goes beyond economic reasoning. Political considerations, especially in East Asia, play a non-negligible role in adopting an international currency.

With the region's predominant antagonism toward hegemony, the PRC's communist political structure, military buildup, and recent territorial disputes with its neighboring countries could seriously impede the acceptance of the RMB abroad and be a drag of its efforts to internationalize the RMB. The PRC has often reaffirmed its commitment to peaceful development, the noninterference foreign policy, and the Five Principles of Peaceful Coexistence. [26] Nevertheless, for its neighboring countries, these reassurances may not be completely convincing, especially when the PRC is expanding its military capacity and continuing its territorial disputes with countries including Japan, the Philippines, and Viet Nam. All these considerations would require the PRC to make some extra efforts to promote the acceptance of the RMB in Asia and in the global market.

Recently, there have been some apparent international efforts to contain the PRC's influences. For instance, the absence of the PRC in the negotiations of the Trans-Pacific Partnership is unlikely to be an unintended omission. [27] The partnership is ostensibly aimed at enhancing trade and investment activities between the US and the major trading countries on both sides of the Pacific Ocean. It is hard to conceive that it is a coincidence for such a trade and investment arrangement to leave the PRC, which is the world's second largest economy and trading nation in the region, on the sidelines.

Overall, to facilitate the global use of the RMB, offshore markets have to overcome limits defined by economic and political factors.

6. CONCLUSIONS

The history of international finance offers a good glimpse of the potential role of an offshore market. Active offshore markets such as the eurodollar markets are essential for a currency to realize its role in the international money system. It is hard to imagine that a currency could maintain its significant presence as a global currency without the backing of a fully functional offshore market network.

The launch of offshore RMB business in Hong Kong, China in 2004 was the beginning of a grand economic experiment. Even though countries in the past had policies promoting the international status of their currencies,[28] the PRC's approach to build the architecture almost from scratch is quite deliberate and elaborate.

The evolution of the offshore RMB market in Hong Kong, China illustrates both potentials and limitations of the policy-driven approach to promote the extraterritorial use of the RMB. So far, the offshore market has advanced to the PRC's tune and experienced no major disruptions. Over the last few years, global RMB activity has

[26] The Five Principles are mutual respect for sovereignty and territorial integrity, mutual non-aggression, non-interference in each other's internal affairs, equality and mutual benefit, and peaceful coexistence. They were results of negotiations between the PRC and India and formally included in the agreement forged between the two countries in 1956. See, e.g., http://www.fmprc.gov.cn/eng/topics/seminaronfiveprinciples/t140777.htm.

[27] The official website is http://www.ustr.gov/tpp.

[28] Eichengreen and Flandreau (2012) pointed out the US policy support that helps the US dollar gain prominence in the global market. The official efforts to internationalize the Japanese yen in the 1990s are documented, e.g., in Takagi (2011).

increased quite noticeably. For instance, the RMB became the ninth most actively traded currency in the 2013 triennial central bank survey, while it ranked 17th in the 2010 survey (BIS 2013). Expansions of both onshore and offshore RMB trading have contributed to the move up in ranking.

Despite the strong momentum, the scale of RMB uses in the global market is still minute compared with the size of the PRC economy and with the US dollar. For instance, global RMB trading accounted for 2.2% (out of a total of 200%) of the global trading volume, while the US dollar accounted for 87.0% and the euro accounted for 39.1% (BIS 2013). In addition, the international currency functionalities undertaken by the RMB are quite limited and the level of nonresident participation is relatively low (Chen and Cheung 2011).

Thus far, the anecdotal evidence substantiates that (i) the positive effect of the offshore market on the international use of the RMB, and (ii) the path for the RMB to become a full-fledged global currency is likely to be a fairly long, if not winding, one. A positive and encouraging sign is that the PRC has been adjusting and reforming domestic policies and offshore strategies on promoting and enhancing overseas RMB markets and RMB businesses.

While the offshore markets play a constructive role and offer a scope for corporations and governments to work together to explore opportunities of using the currency in an efficient manner, we should not overplay the contribution of offshore RMB markets. On the one hand, with improved liquidity and enhanced investment opportunities, offshore markets offer opportunities to nonresidents to experience business dealings using the RMB and the PRC authorities to assess the implications of intermediating international transactions without eradicating capital controls. On the other hand, as in the past, the PRC maintains its usual gradual approach to liberalizing its economy including its finance sector, retains its grip on critical policy matters, and responds mainly to domestic rather than foreign considerations.

In the foreseeable future, we anticipate the offshore RMB market will grow at a healthy pace that is directed and dictated by the PRC authorities. With the emphasis on stability, the PRC will assume an active role in designing the offshore market development and be very conscientious about the adverse feedback on its underdeveloped finance sector.

The offshore market policy is used to improve the RMB’s overseas acceptance but is subordinate to the overall financial liberalization policy. It generates information to make changes but not to force domestic regulatory reform. That is, the role of offshore markets is complementary in the sense that it helps the RMB achieve its potential as a global currency but not to force changes in domestic policies to further the role of the RMB in the global market.

Alternatively, the observed developments could be interpreted through the lens of the so-called “feel the rock, wade across the river” strategy. Under this strategy, the policies are contemplated and designed in broad and general terms. The operational specifics, however, are introduced and implemented in small and incremental steps, taking the market responses into consideration, to guard against large negative surprises. Indeed, the PRC has initiated changes to accommodate and complement developments in the market since the adoption of the open-door policy. The case of RMB offshore markets is no exception. Specific policies that do not threaten the stability are introduced to promote the overall international use of the RMB in a gradual manner.

The experience of, say, the eurodollar market suggests that the offshore market could create pressure on the domestic policy. Since its size is relatively small, the offshore RMB market is unlikely to generate any noticeable pressure on the PRC's domestic market and, hence, its domestic policy. The PRC's capital control policy also helps to insulate its domestic sectors from the offshore market. When the offshore RMB market is quite large relative to the one onshore and the PRC's capital control policy is so lax that it allows offshore financial institutions directly to compete with and challenge onshore financial institutions, then the domestic policy has to respond to developments overseas. It is not unreasonable to assume that the PRC is aware of the potential shock and risk to its underdeveloped finance sector when overseas financial institutions are allowed to compete head-on with the domestic institutions. Given the usual emphasis on stability and political reality, it is unlikely that the PRC will allow the offshore market to impose any material pressure on the domestic policy in the near future.

In sum, the PRC has made some good efforts in preparing for full convertibility and the internationalization of its currency. While the accomplishment in the last few years is quite admirable, the RMB is still quite far from being a full-fledged international currency. To move forward, the PRC has to continue its financial market reform, liberalize the capital account, and enhance the efficiency and governance of the finance sector. The effort of promoting the international use of the RMB will be reinforced by engaging with the world in a responsive and responsible manner.

A well-designed network of offshore markets will advance the overseas acceptance and solidify the international status of the RMB. However, the ultimate acceptance of and demand for the RMB as a global currency are determined by the underlying economic forces shaped by the PRC's economic fundamentals, and the global political dynamics. Offshore RMB markets themselves could not raise the RMB's status beyond what is justified by its economic and political attributes.

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