STRATEGIC FRAMEWORK OF THE MNB'S RENMINBI PROGRAMME AND THE INTERNATIONAL PRACTICE

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Which central bank responsibilities may be affected by the internationalisation of the renminbi? In relation to the announcement of the Central Bank of Hungary's (MNB) Renminbi Programme on 19 February 2015, our background paper seeks an answer to this question by presenting the international practice and the strategic issues faced by the MNB. This article addresses four issues related to central bank responsibilities in relation to the use of the renminbi: (i) monetary policy instruments; (ii) the renminbi foreign exchange reserve portfolio; (iii) financial stability and supervisory duties in the context of the use of the renminbi and the cross-border activities of Chinese banks; and (iv) issues regarding the development of the payment infrastructure.

This analysis is the third part of a series of articles. The first part of the series presented the milestones of the international introduction of the renminbi. The second part described the exchange rate policy of the People's Bank of China and the details *of its foreign currency swap agreements with other central banks. The closing articles of the series are providing an overview of the most important characteristics of international renminbi centres and the envisaged liberalisation of the Chinese capital account.*

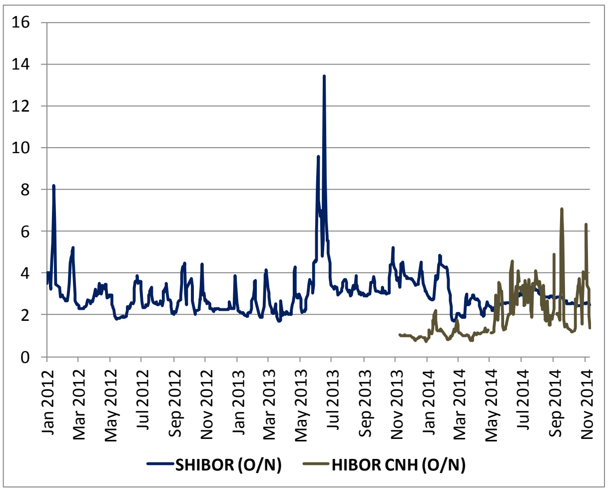
1. CENTRAL BANK RENMINBI FACILITIES RELYING UPON SWAP LINE AGREEMENTS

Relying upon the Chinese swap line agreements, several central banks have introduced renminbi facilities in recent years. The majority of central banks aimed at bridging offshore renminbi market liquidity disturbances with the bilateral swapline agreement (Bank of England - BoE, Reserve Bank of New Zealand – RBNZ, Reserve Bank of Australia - RBA, European Central Bank - ECB, Hong Kong Monetary Authority - HKMA, Monetary Authority of Singapore - MAS) and only few have already announced liquidity management facilities (HKMA, MAS). At the same time, some central banks announced renminbi facilities for trade financing as well (Bank of Korea - BoK,MAS) (Table 1).

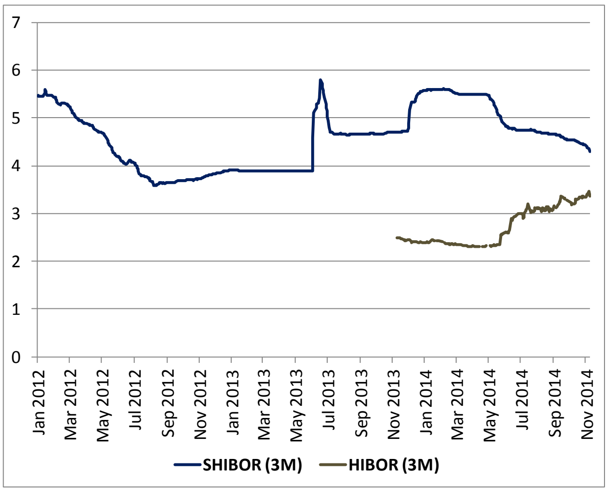
Considering that the renminbi is not fully convertible, and the PBOC intervenes only in the onshore market, international use of the renminbi may require the support from foreign central banks. The imperfection of the passage between onshore and offshore markets is indicated by the spread between interbank rates in onshore (SHIBOR) and offshore (HIBOR) markets at the relevant overnight and three-month maturities. In addition, volatility is higher in the offshore markets.

Chart 1: Onshore (SHIBOR) and offshore (HIBOR) interbank yields (%)

Overnight yields



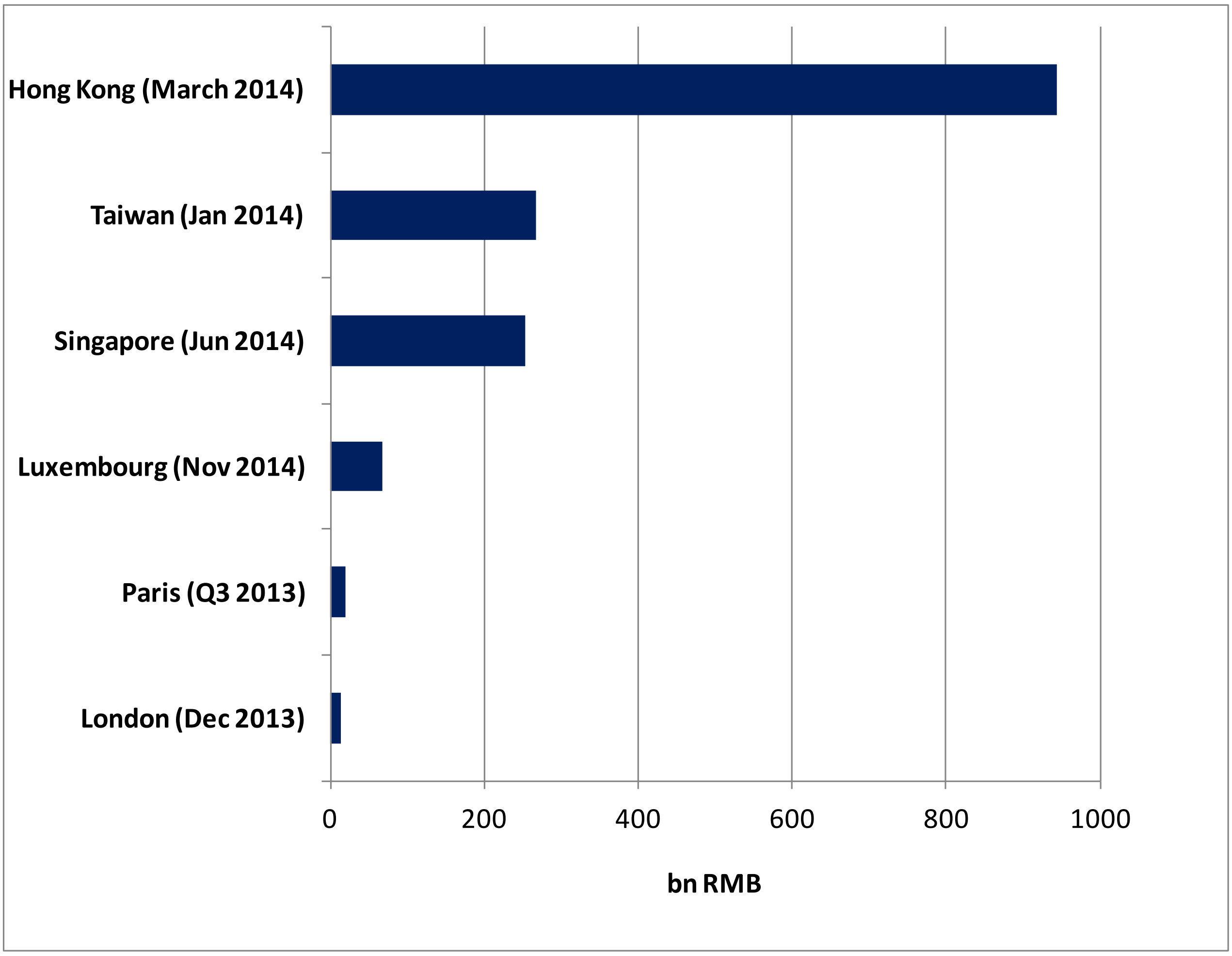
3-month yields



Source: Bloomberg

The sources of offshore market renminbi liquidity are foreign trade settlements and tourism as well as commercial banks' renminbi deposits and also domestic banks' relations with international renminbi hubs (parent banks, access to other central banks' renminbi transactions). Renminbi deposits are concentrated in Hong Kong (Chart 2), and they increased mainly as a result of trade settlements and expectations relating to the appreciation of the renminbi. At the same time, dynamic growth was observed in Singapore, Taiwan in the Asian region and in European hubs as well in the past years. Of the European hubs, in Paris the liquidity relating to Chinese banks' activities in Africa appears as renminbi deposits.

Chart 2: The value of renminbi deposits in offshore hubs (billion RMB)



Sources: HKMA, MAS, Paris-Europlace

The goal of central banks' renminbi facilities is usually of liquidity management nature. Banks may typically draw renminbi funds against the standard eligible collaterals accepted by central banks, with a 1–2-day settlement in the Asian region. In the current settlement system in Europe, renminbi liquidity could be drawn with a longer settlement due to the time lag and the attributes of the renminbi settlement infrastructure. Considering the fact that central banks created the facilities as a kind of backstop facility, the rate of central bank facilities is higher than market rates what discourages recourse to liquidity facilities. Trade financing is provided by the BoK and the HKMA at a more favourable rate, i.e. at the SHIBOR rate corresponding to the funding term.

Table 1 Renminbi instruments of central banks

Central banks	Goal of swapline	Facility announced	Maturity	Settlement	Price
BoE	liqudity backstop				
RNBZ	liqudity backstop				
RBA	liqudity backstop				SHIBOR + 25 bp
MAS	liqudity backstop	X	O/N 1W 1M	t (O/N) t+1 (1W) t+1 (1M)	O/N - minimum CNH HIBOR 1W - SHIBOR 1M - SHIBOR
	trade finance	X	3M	t+1	SHIBOR
HKMA	liqudity backstop	X	ON, TN, 1W	t (O/N), t+2 (TN,1W)	according to market rates
BOK	trade finance	X	3M, 6M		SHIBOR
ECB	liqudity backstop		1W	t+4	SHIBOR + 100 bp

Sources: BoE, BoK, ECB, HKMA, MAS, RBA, RNBZ

According to central bank intelligence information, the ECB and other ESCB central banks have not yet carried out any drawings in the framework of the swap line agreement concluded with the PBOC, and have not announced renminbi liquidity facilities. Pursuant to the agreement, similarly to other central banks, the ECB could draw renminbi liquidity at maturities up to one year.

The Bank of Korea (BoK) introduced its renminbi facility for trade financing with 3 and 6 month maturities in December 2012.[1] Together with the background documentation, the financing requirement relating to export financing transactions is assessed by the BoK. The rolling and early repayment of central bank RMB funds is supported by the BoK.

However, active use of the trade finance facility of the BoK has not taken place since the announcement, in spite of the fact that the credit cost is aligned to the SHIBOR Chey (2014).[2] Namely, the financing through the central bank (SHIBOR) is not necessarily cheaper than offshore financing (HIBOR) (see the difference between the two rates in Chart 1).

According to the RBNZ: The currency swap agreement between the RBNZ and PBC has not been used in the previous years. The facility was initially put in place for emergency liquidity provision purposes as the market had limited access to RMB funds. The RBNZ's newly renewed agreement with PBOC has improved operational terms and conditions. It permits swap initiation for not only

1 http://www.bok.or.kr/down.search?file_path=/attach/eng/634/2012/12/1354590679949.pdf&file_name=20121204_press+release_%28engl%29.pdf

2 Hyoung-kyu Chey (2014): A Demand Side Analysis of Renminbi Internationalisation: The Renminbi in South Korea, GRIPS Discussion Paper 14-02 http://www.grips.ac.jp/r-center/wp-content/uploads/14-02.pdf

trade finance, but also investment related flows (not permitted in the previous version). In general, the arrangement is designed in a way to promote the usage of the facility.

The RBA may provide RMB loans at SHIBOR+25 basis points. Based on the study by Eichengreen (2014), the swap facility may serve to mitigate the liquidity troubles of the market, and may provide greater security for settlements in renminbi for the companies participating in trade and financial transactions.

The objective of the overnight facility of the MAS is to facilitate short-term financing of the markets up to an amount of RMB 5 billion.[3] For liquidity allocation, daily competitive auctions are held, during which the **minimum financing rate is the HIBOR rate of the CNH**. Although central banks typically price their renminbi facilities to the SHIBOR rate, in the case of the overnight facility the MAS has to hold own liquidity, and its opportunity cost is the offshore overnight rate (O/N HIBOR).

In addition, the MAS announced 1-week and 1-month liquidity facilities as well as a 3-month trade financing facility. [4]

Key issues related to the instruments of the MNB's Renminbi Program:

- Investigation whether renminbi liquidity instruments can/should be applied.
- Investigation of the implementation issues and conditions of possible liquidity instruments.

2. CENTRAL BANKS' RENMINBI INVESTMENTS

"(…)in the last few years, central banks across the world have started to hold onshore Chinese renminbi (CNY) in their reserves portfolios, usually with the expectation that CNY may become a reserve currency in the coming years. Many others indicate interest in reserve asset diversification into CNY once China's onshore market opens up further. This is an issue that the Eurosystem will also have to further reflect on in the future. ***Benoît Cœuré, ECB Executive Board member 17 November 2014***[5]*"*

Since the liberalisation of the capital account of China started, central banks have been among the first institutions to be allowed to carry out portfolio investments in the Chinese capital market, and in the past years an increasing number of monetary authorities purchased renminbi assets. China's credit rating is good, and renminbi instruments ensure an opportunity for diversification and a relatively high yield. In their communication related to renminbi investments, central banks also mentioned that renminbi investments may contribute to the develop-

3 http://www.mas.gov.sg/monetary-policy-and-economics/central-bank-operations-and-liquidity-management/mas-overnight-rmb-liquidity-facility.aspx

4 http://www.mas.gov.sg/monetary-policy-and-economics/central-bank-operations-and-liquidity-management/mas-rmb-facility.aspx

5 http://www.ecb.europa.eu/press/key/date/2014/html/sp141117_3.en.html

ment of trade and financial relations with China. On the other hand, the limited convertibility of RMB-denominated assets have deterred most central banks from investing a sizeable share of their reserves in onshore markets.

A small group of central banks have already started to develop a renminbi portfolio. Nevertheless, the share of renminbi investments within the whole FX reserve portfolio is typically small, around 1–3 per cent. An even smaller group of central banks holding renminbi instruments disclosed the details of their renminbi investments (BoE, RBA, Central Bank of Chile), while other central banks also communicated their intentions (BoK, BoN - Bank of Nigeria, etc.).

The BoE holds FX reserves worth RMB 3 billion funded by the Treasury RMB bond issuances in October 2014. The maturity of the FX reserve assets is 3 years, in line with the government's renminbi bond issuance. The government issued renminbi bonds with a maturity of 3 years and a coupon yield of 2.7 per cent. The bonds were subscribed by institutions belonging to the following investment categories: banks subscribed 64%, central banks and official institutions 17% and fund managers 19%. Asian investors subscribed more than 50%, European investors 33%, while the rest was subscribed by American investors. The issuance was organised by the Bank of China, HSBC and the Standard Chartered Bank.

At present, the RBA holds renminbi instruments amounting to USD 1055 million, corresponding to 2 per cent of its foreign exchange reserves (RBA, 2014)**..**

2.1. Choice between offshore and onshore market investments

Based on market and central bank intelligence, setting up an onshore renminbi portfolio is a protracted process burdened with challenges. These challenges include the dissolving of differences in legal norms, the creation of technical conditions as well as the difficulties of the follow-up and repatriation of investments. Therefore, some central banks appeared in the offshore market as well, or invested in the onshore market through the BIS.

However, from an economic diplomacy aspect, offshore market appearance may even be advantageous, because it supports the steps taken by Chinese parties in order to provide offshore market liquidity.

At the same time, there is not much liquid issuance in the offshore market yet, although supranational and sovereign bonds are available as well. For example, the bonds of the German **KfW Group** (Kreditanstalt für Wiederaufbau), the **IFC** (International Finance Corporation) and the **IBRD** (International Bank for Reconstruction and Development) as members of the World Bank Group, the United Kingdom or perhaps of the Canadian province British Columbia, which are all AAA rated. China also issues Dim Sum bonds[6]; the last issuance was in Hong Kong on 20 November 2014. The usual maturities are 2–3 years, satisfying the preferences of the majority of reserve managers. Issuers were previously attracted by the fact that financing in renminbi was cheaper,

[6] The renminbi bonds issued outside China are called Dim Sum bonds.

but this has not been the case recently. Primary market purchases are typical in the offshore market, because the majority of investors hold the securities until maturity.

In view of the challenges of onshore market investment, some central banks invest in Chinese instruments through the BIS Investment Pool (BISIP CNY).

Key reserve management issues related to the MNB's Renminbi Program:

- Investigation whether a small portion of the foreign reserves could be invested in renminbi assets.
- Investigation of the implementation issues of a possible renminbi portfolio (advantages and disadvantages of onshore or offshore investments, etc.).
- Investigation of the funding of the possible renminbi portfolio (conversion, issuance of bonds, etc.)

3. SUPERVISORY AND FINANCIAL STABILITY ISSUES

Prior to the liberalisation of the capital account and the introduction of full convertibility, the strengthening of financial regulation and prudential supervision as well as the achievement of central bank independence are important tasks in China; Eichengreen et al. (2014).[7] The analysis sees risks, inter alia, in the shadow banking activities of Chinese banks. The interbank liquidity tensions in 2013 (overnight interbank rates rose from the usual level of around 4 per cent to 25 per cent) drew attention to the importance of these risks (Chart 1). Similar problems may be amplified by the liberalisation of the capital account in the future, posing challenges to regulators and supervisory authorities at home and abroad as well. For the time being, the institutional system for the management of financial stability risks is also underdeveloped (deficiencies of deposit insurance and investment protection institutions, necessity of the development of the company information system and credit rating, etc.).

Currently it is not possible to assess the risks of the offshore renminbi market structures that are being developed, and – according to central bank analyses – the liberalisation of China's capital account may increase financial stability risks. On the basis of earlier experiences of capital account liberalisations, a recent **BoE Quarterly Bulletin article**[8] warns that the process of liberalisation can be accompanied by an increase in the risks to financial stability. According to the opinion of the MAS, the implementation of the liberalisation requires adequate sequencing. For example, a too early liberalisation of capital controls prior to the liberalisation of interest rates may result in capital outflows. In addition, interest rate liberalisation may add to the costs of banks, reduce profit rates and increase the risks of the Chinese banking sector. Central banks' investment experiences indicate that due to language barriers and the existing decision making

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[7] Eichengreen et al. (2014): Internationalisation of the renminbi, March 2014, Research Report, Center for Financial Research

[8] Hooley, J. (2013): Bringing down the Great Wall, Quarterly Bulletin, 2013Q4, Topical articles http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2013/qb1304prereleasechina.pdf

structures, decisions are often made slowly, which may hinder the management of crisis situations.

Several central banks concluded new agreements (MoU – Memorandum of Understanding) on supervisory issues in recent years, partly due to the growing importance of the Chinese financial relations. In view of the more active Chinese presence and RMB use, it is worth considering to expand supervisory cooperation to issues that were not regulated in previous agreements, when Chinese capital controls were stricter. The clearing MoUs between the Chinese central bank and the BoE, BCL - Banque Centrale du Luxemburg, BdF - Banque de France and BOK also suggest closer supervisory cooperation. According to recent annuncements, central banks aim at closer cooperation with the Chinese authorities in relevant supervisory issues, share the necessary information and continuously evaluate the possibilities of enhanced cooperation.

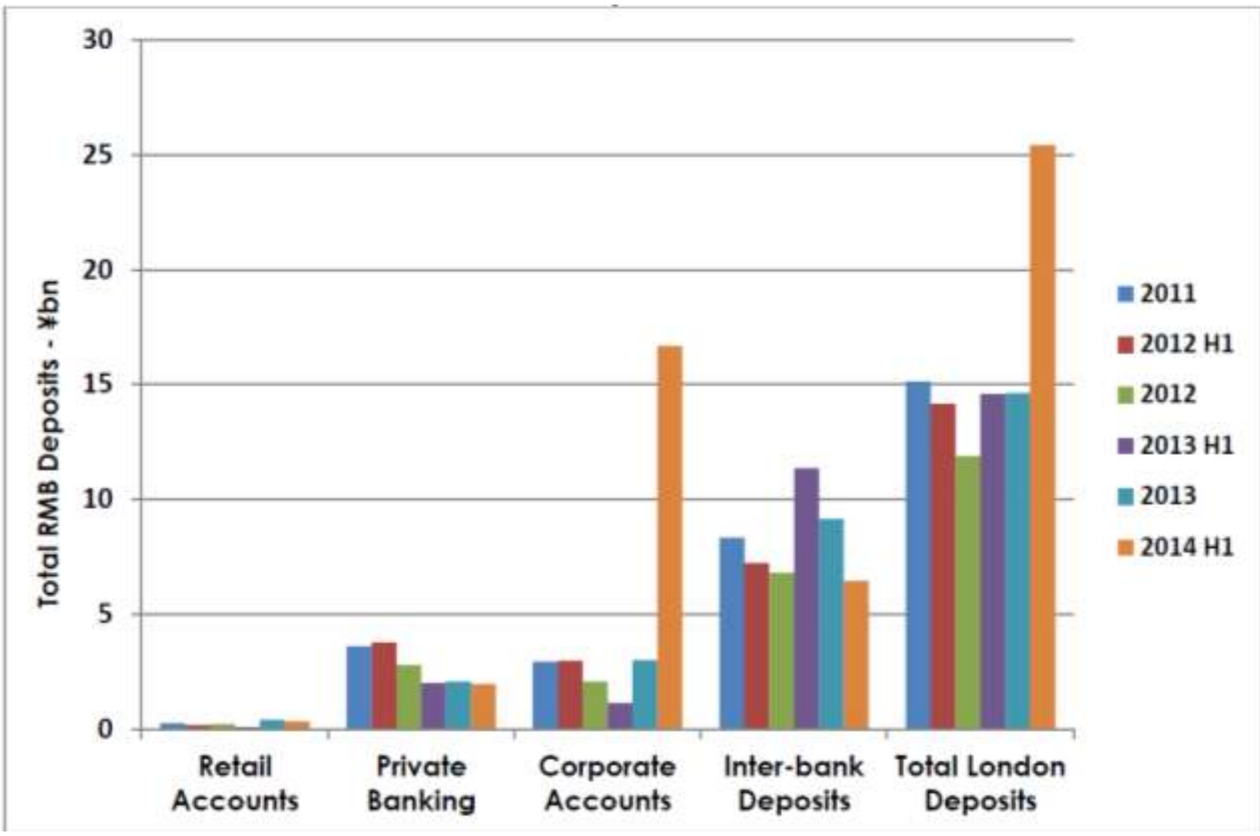
Relying upon the experiences of the crisis, in the case of banks providing cross-border services, the United Kingdom expected them to operate as subsidiaries, because this form may provide greater security for depositors and tax payers compared to foreign branches. The PBOC confirmed the appointment of the China Construction Bank (CCB) as official clearing bank in the United Kingdom (June 2014). The CCB will provide services as a subsidiary.

Relying upon the experiences of the crisis, the British authorities intended to limit the list of activities as well in the United Kingdom.

> *"We do not wish to see non-EEA branches undertaking critical retail banking functions – like taking deposits – beyond de minimis levels unless there is some good reason and importantly there is a very high level of assurance on resolution."* Andrew Bailey, Bank of England, 2013.

Based on renminbi deposit holdings, deposit taking activity, which is considered critical, has not increased to a great extent in the United Kingdom.

Chart 3: Renminbi deposits in London (billion RMB)



Source: City of London

Regarding financial stability developments it should be considered that Chinese banks usually establish regional centres, and their fund raising may increase the domestic banking sector's short-term external liabilities and thus leading to worsening central bank's foreign reserve adequacy and increasing vulnerability in non-euro area countries.

During the 2008 crisis, non-euro area EU member countries experienced the risks stemming from the use of foreign currency. Therefore, when a central bank encourages the international use of the renminbi, it is important that banks' currency mismatch should not deteriorate, and dependency on foreign parent banks should not increase excessively.

For ESCB central banks it is an important economic strategy and financial stability issue to what extent to encourage the use of the renminbi for commercial and financial settlements for replacing the earlier intermediary currency (USD) and whether supporting the use of the euro, which has a much more developed market is more beneficial. The advantages of the settlement in renminbi include that transaction and invoicing costs may be reduced, and the settlement can be accelerated as a result of the elimination of the intermediary currency (typically the USD). In addition, settlement in the partners' currency may mean a competitive advantage, and trading partners may make themselves independent of possible liquidity turbulences of third currencies used in trading. Partners' foreign-exchange risk may also decline, contributing to the accuracy of pricing and facilitating corporate planning as well. Finally, foreign economic relations may be strengthened, and the system of foreign economic relations becomes more diversified. At the same time it is important to take into account that the Chinese financial and settlement system carries operational risks, which may cause difficulties during settlements especially in crisis situations. Liquidity problems may occur as a result of a rapid upswing in renminbi settlements as well due to problems in the renminbi markets. Furthermore, the safety net based on the Chinese swap line agreement is not yet fully operational in practice. **Settlement in euro would have similar types of advantages as settlement in renminbi due to the elimination of the intermediary currency (dollar)**, but the liquidity of the euro financial markets is much better than that of the renminbi offshore markets, and it provides one of the highest quality financial services globally.

Key financial stability and supervisory issues related to the MNB's Renminbi Program:

- Investigation of the risks related to the increasing renminbi market activity and monitoring of Chinese credit institutions, especially with regards to cross-border activity and to risks stemming from contagion and imbalances of the Chinese financial system.
- Cooperation with Chinese supervisory authorities and strengthening of the supervisory coordination and information sharing procedures.

4. CLEARING AND SETTLEMENT ISSUES

The fundamental condition of using the renminbi outside China is to create a clearing and settlement infrastructure for carrying out renminbi transactions, which can be implemented in several steps. In the first step the Chinese banks that are present in Europe (currently Agricultural Bank of China – ABC, the Bank of China - BoC, the Industrial and Commercial Bank of China - ICBC and the CBC) may function as typical commercial banks and provide correspondent banking services, maintain renminbi payment accounts for banks and companies, allowing the execution of payment transactions launched in renminbi among account holders within the bank and also carrying out cross-border renminbi transactions through their parent bank. Smooth service provision also requires that the PBOC designate the Chinese bank as official clearing bank. Namely, official clearing banks are able to ensure access to the Chinese systems and markets in a more direct manner, which may presumably allow the provision of faster, cheaper and also more comfortable payment services for clients. In addition, the advantage of the appointment of official clearing banks is that they receive quotas to the onshore FX market and bond market as well.

The PBOC concluded agreements relating to clearing and settlement issues with central banks typically after the swap line agreement had been signed, and the official clearing bank was also appointed simultaneously (Table 2). China's leading banks received official clearing bank status:

- the Bank of China (BoC) in Australia, South Korea, Hong Kong, Frankfurt and Paris,
- Industrial and Commercial Bank of China (ICBC) in Singapore, Qatar and Luxembourg, and the
- China Cosntruction Bank (CCB) in the United Kingdom.

Table 2: Details of Chinese swap line agreements and clearing and settlement agreements

	Swapline agreement	Official settlement bank		
		MoU on clearing arrangement	settlement bank	settlement bank announcement
South Korea	2008	03/07/2014	BoC	14/07/2014
Hong Kong	2009	19/03/2009	BoC	2007
Singapore	2010	08/04/2013	ICBC	08/02/2013
New Zealand	2011			
Australia	2012			
Germany	2013	28/03/2014	BoC	19/06/2014
United Kingdom	2013	31/03/2014	CCB	18/06/2014
Luxemburg	2013	28/06/2014	ICBC	23/09/2014
France	2013	30/06/2014	BoC	23/09/2014
Hungary	2013			
Switzerland	2014	27/01/2015		
Qatar	2014	13/11/2014	ICBC	14/11/2014
Malaysia	2009		BoC	08/01/2015
Thailand	2011		ICBC	08/01/2015

In the euro area, the clearing and settlement was launched in Frankfurt in collaboration with the Bank of China in November 2014.[9].

The MAS concluded an agreement (MoU) on RMB-related cooperation, clearing and settlement issues, liquidity conditions and RMB stability issues in April 2014. In Singapore, the Singapore branch of the ICBC has been the official RMB clearing bank designated by the PBOC since February 2013. The bank started to provide clearing and settlement services last May; strong and rapid growth has been observed in the renminbi market since then. According to a statement[10], the establishment of the clearing bank allows the development of foreign trade and financial relations, and may improve RMB liquidity in Singapore, while a wider range of RMB products and services becomes available in Singapore, better satisfying market financing, investment and risk management needs.

At present, there are three Chinese banks in New Zealand: the ICBC NZ Ltd., the BoC NZ and the CCB NZ.[11] According to the information from the Reserve Bank of New Zealand, RMB is not a mainstream settlement currency yet, with only about 2% of world trade settlement in 2014 and even less in New Zealand. One important reason why so little China/New Zealand trade is currently invoiced and settled in RMB is the dominance of commodity exports (e.g. dairy and other primary products) which are typically priced and settled in USD. Thus far, New Zealand has not

9 http://www.frankfurt-main-finance.de/de/ueber-uns/presse/pressemitteilungen/pressemitteilungen-2014/renminbi-clearing-am-finanzplatz-frankfurt-gestartet/

10 http://www.mas.gov.sg/news-and-publications/speeches-and-monetary-policy-statements/2014/singapores-perspectives-on-rmb-internationalisation.aspx

11 http://www.rbnz.govt.nz/regulation_and_supervision/banks/register/

got any RMB clearing arrangement or immediate intention to establish such a facility. Neverthe-less, the RNBZ has been monitoring closely the development of offshore RMB clearing hubs.

Key clearing and settlement issues related to the MNB's Renminbi Program: • Planning of the clearing and settlement infrastructure and elaboration of the related Memorandum of Understanding. • Supporting the appointment of the official renminbi clearing bank.

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Annex: Announcement of the Hungarian Central Bank's Renminbi Programme (JRP)

In connection with the foreign exchange swap agreement concluded with the People's Bank of China, the Magyar Nemzeti Bank is announcing the start of the Hungarian Central Bank's Renminbi Programme (JRP) as of the first day of the Chinese New Year. Internationalisation of the renminbi is a high-priority objective of Chinese economic policy, which is supported by a series of actions by foreign governments and central banks.

By now, China has become one of the most important trading partners of the European Union. In parallel with the liberalisation of China's capital account and exchange rate regime, the transformation of the Chinese savings portfolio and financing structure can provide countries of the EU with financing and diversification opportunities. Hungary plays a special role in China's relations with the region: the Magyar Nemzeti Bank has been the only central bank in Central and Eastern Europe to have concluded a foreign exchange swap agreement with the People's Bank of China; Hungary is where the only Chinese commercial bank operates within the region; and in recent years Hungary has become one of the most important regional target countries of Chinese investment capital flows and migration.

After reviewing the actions taken by the members of the European System of Central Banks participating in renminbi settlements, the MNB has started to develop the financial infrastructure and institutional structure as part of the Hungarian Central Bank's Renminbi Programme. This will facilitate the utilisation of advantages arising from the renminbi internationalisation and due to the role of Budapest in the region it can generate cross-border market activity and income for both Hungary and Central and Eastern Europe.

In connection with the Central Bank Renminbi Programme, the Magyar Nemzeti Bank will launch the Budapest Renminbi Initiative in 2015. The purpose of the Initiative is to expand the investment spectrum and financing sources of Hungary. Important goals of the MNB with the programme are to create money-, foreign exchange and capital market infrastructures, develop the clearing and settlement system and start negotiations about Chinese capital market licences in cooperation with the major stakeholders of renminbi settlements in the financial, corporate and government sector.

Within the framework of the Central Bank Renminbi Programme (JRP), the MNB will examine the following questions in 2015:

- renminbi foreign exchange reserve portfolio,
- central bank renminbi liquidity instrument to deal with market disturbances,
- development of the renminbi clearing and settlement infrastructure,
- financial stability and supervisory issues related to the use of the renminbi and the cross-border activity of Chinese banks.

19 February 2015