

RMB

Internationalization:

A Ten-year Review

Dec 2019

Index

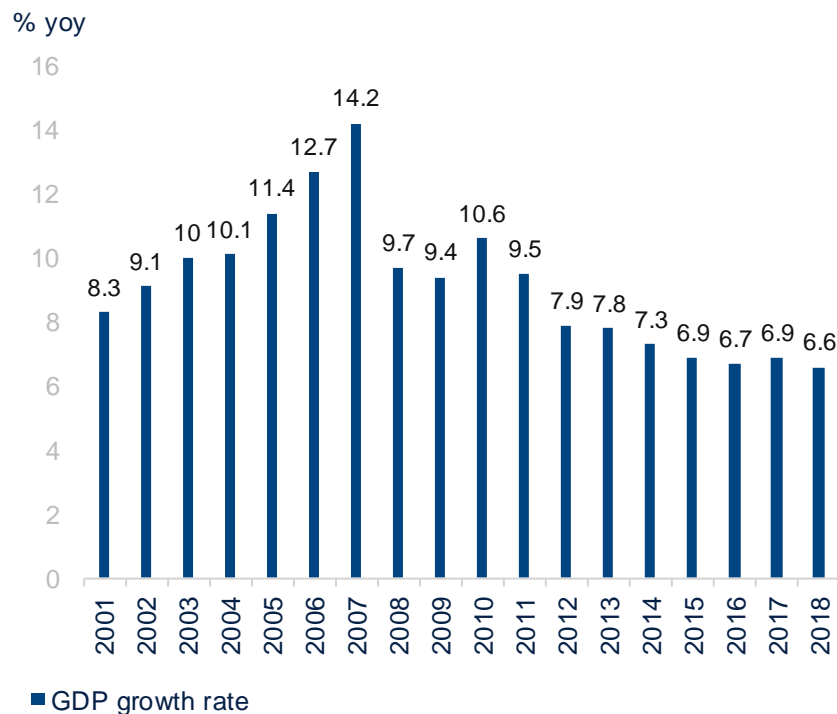
- 01 The origin and background of RMB Internationalization
- 02 Strategies to increase overseas usage of RMB
- 03 Taking stock of early fruits
- 04 “811” devaluation and its implication
- 05 Next breakthrough: The opening-up of RMB bond market

01

The origin and background of RMB Internationalization

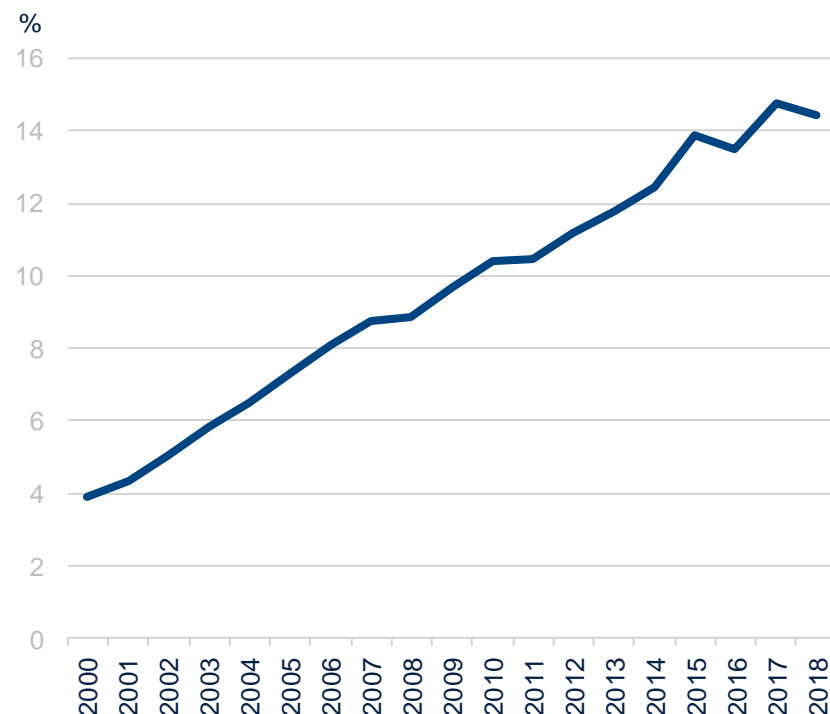
China's pivotal role in the global economy

CHINA HAS BECOME THE WORLD'S SECOND LARGEST ECONOMY



Source: Haver & BBVA Research

CHINA'S SHARE OF WORLD EXPORTS HAS RISEN STEADILY

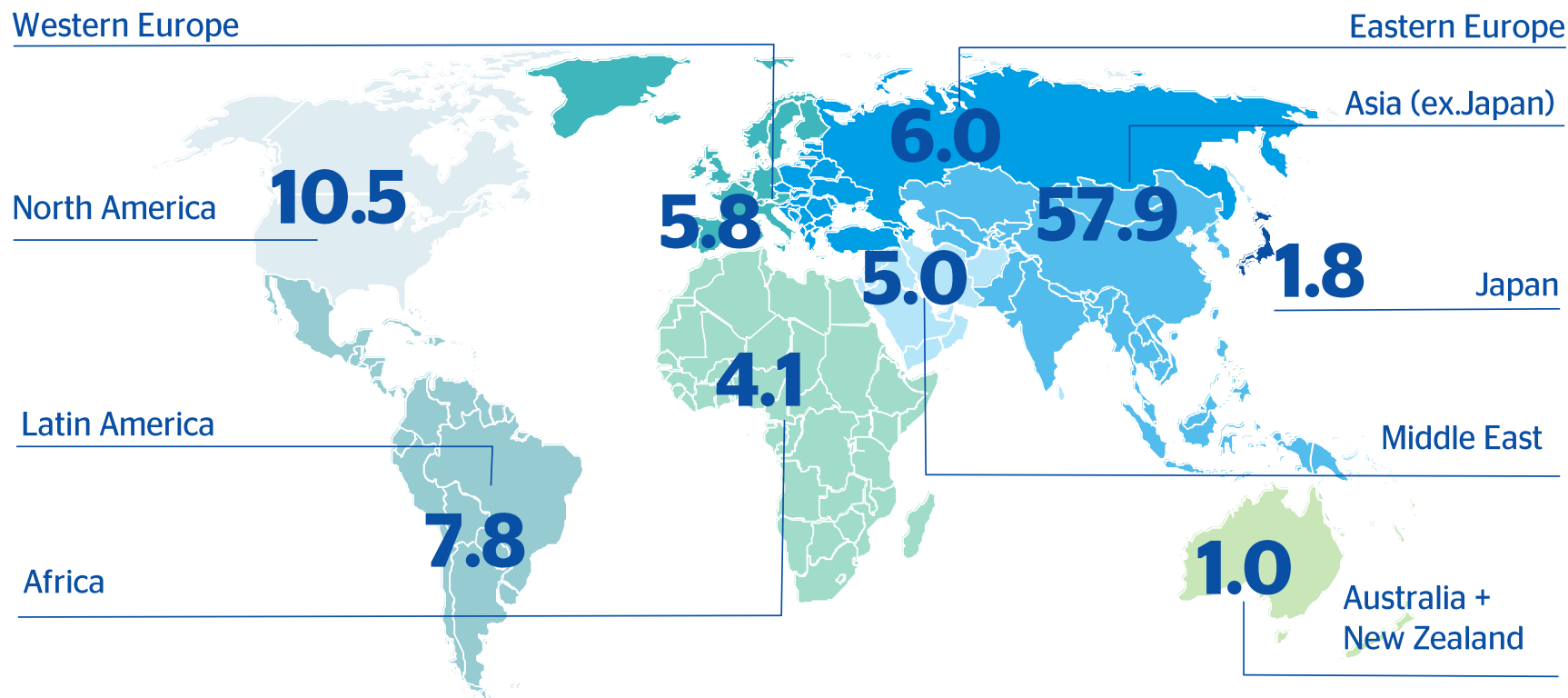


Source: Haver & BBVA Research

China's economic growth has maintained a breakneck pace over the past decade, lifting itself to the second largest economy in the world. China's accession into WTO boosted its exports share in the global market (the largest exporter).

China is anticipated to be the largest contributor to global growth

CONTRIBUTION TO GLOBAL ECONOMIC GROWTH BY REGION, 2011-2021
(%)

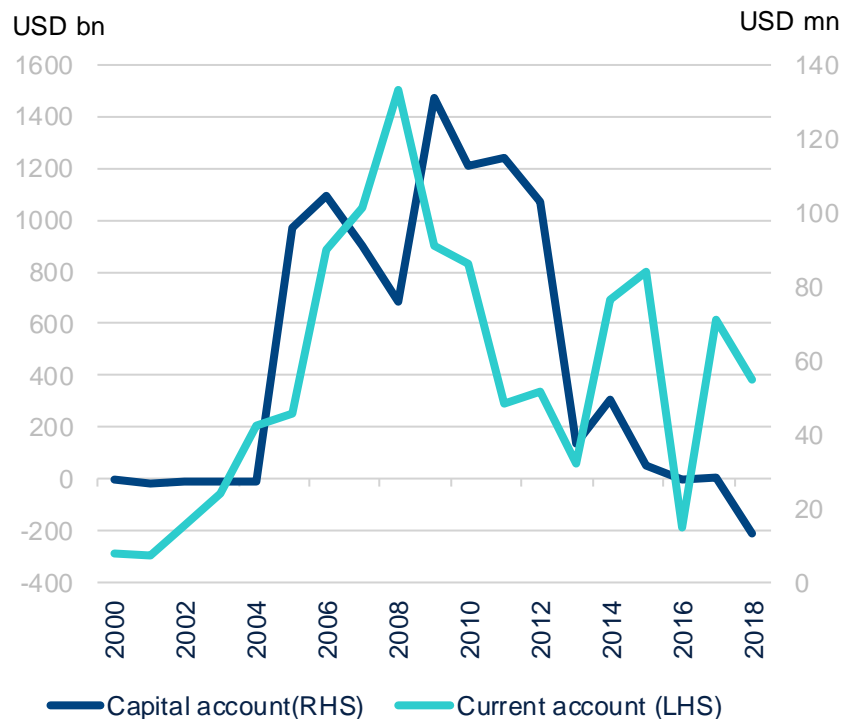


Source: IMF WEO & BBVA Research

We project that China will continue to be the largest contributor to global growth (34% over 2011-2021). Emerging Asian economies to contribute 58% to global growth over the same period.

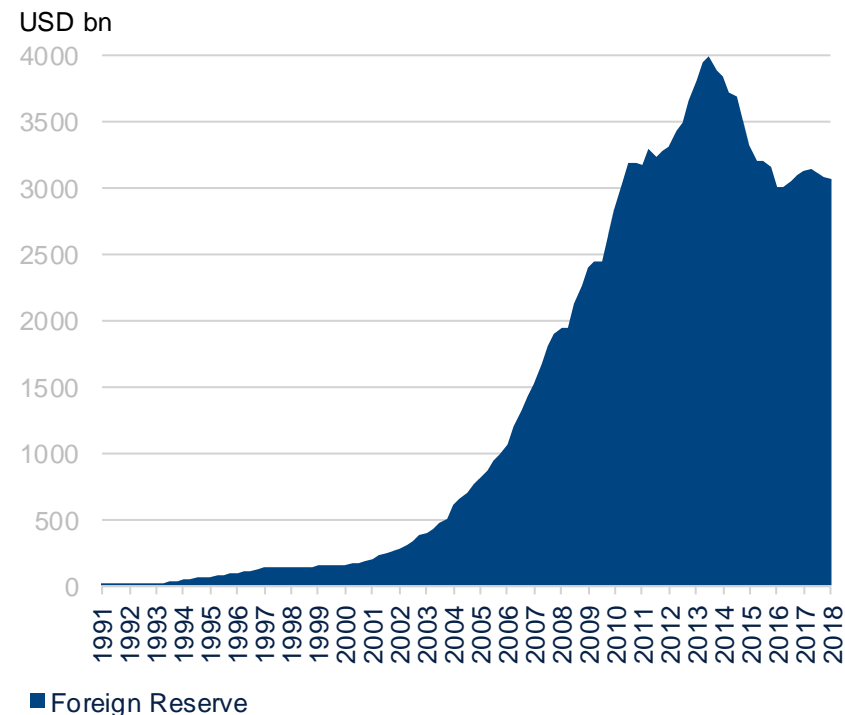
“Twin Surplus” and massive FX reserves

LONG-TERM TWIN SURPLUS IS A UNIQUE PHENOMENON



Source:Haver & BBVA Research

CHINA'S FX RESERVE IS NO.1 IN THE WORLD



Source:Haver & BBVA Research

Lurking behind the “Twin Surplus” (current and capital account) are an undervalued exchange rate and asymmetric restrictions under the capital account. The government intervention in FX market resulted in massive accumulation of FX reserve.

...However, the international status of the RMB remained low pre-global financial tsunami

WHAT MAKES AN INTERNATIONAL CURRENCY

International functions of a global currency

Role of the currency	Official use	Private use
Store of value	Currency of international reserves	Currency substitution (dollarization)
Medium of exchange	Vehicle currency for foreign exchange intervention	Invoicing of trade and financial transactions
Unit of account	Anchor for pegging a currency	Denomination (value) for trade and financial transactions

Source: Kenen (1983) and Chinn and Frankel (2005) & BBVA Research

The use of the RMB in international markets is disproportionately low relative to China's economic size (0.04% in 2nd half of 2009). China's authorities aspired to internationalize RMB.

Drawing on international experience of currency internationalization

**International
currency → More
overseas demand
for the currency →
Currency
appreciation →
negative impact on
trade sector.**

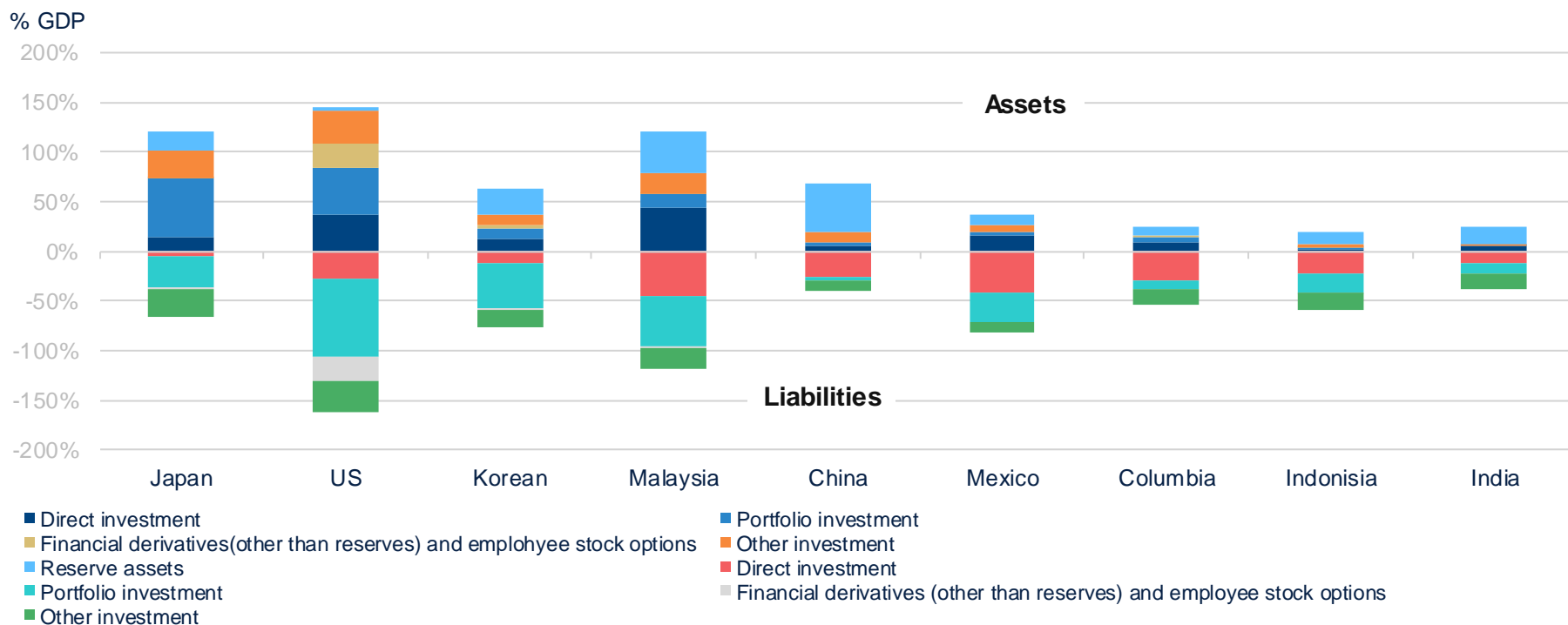
**German authorities
were reluctant to
internationalize
its currency.**

**Internationalization
before capital
account
liberalization.**

Potential Motif 1: China as a large external creditor

INTERNATIONAL INVESTMENT POSITION 2010

(% OF GDP)



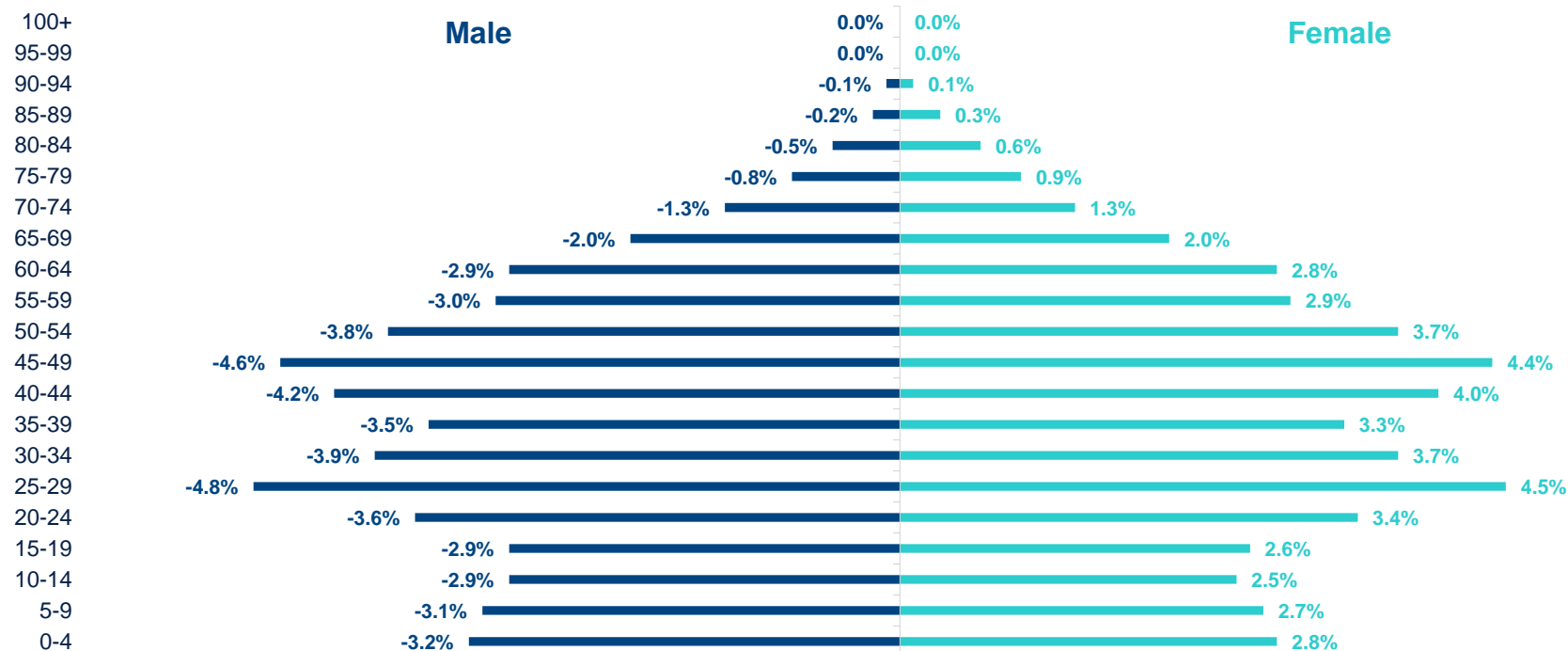
Source: IMF & BBVA Research

China's FX reserves account for a large part of its international asset and national savings. Appreciation of the RMB could result in grave losses of national savings.

Potential Motif 2: Aspiring for “exorbitant privilege” to overcome long-term challenges

CHINA
2016

Population
1,382,323,331

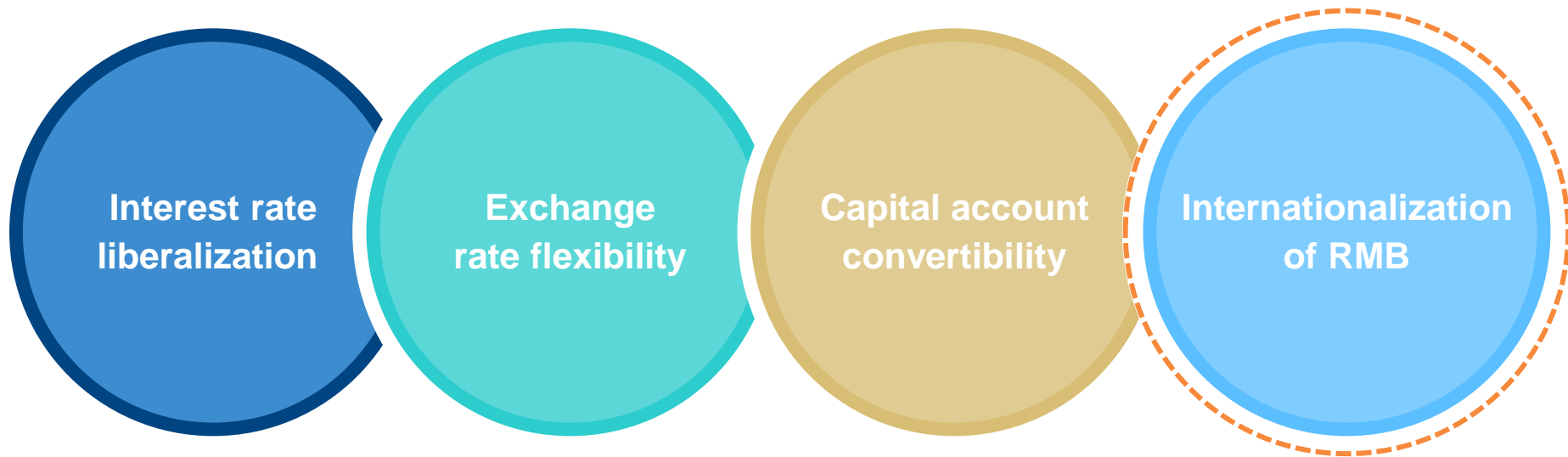


Source: IMF & BBVA Research

A fast aging society requires for huge pension/medical expenses.

The privileges of reserve currency could help China to cushion its domestic (debt) and external shocks.

Potential Motif 3: Catalyzing other financial reforms (conspiracy theory)



Source: IMF & BBVA Research

Some reform-minded technocrats sought to use RMB internationalization to press ahead with other important reforms of China's financial system.

Has the RMB internationalization achieved the goals?

**Diversified
reserve assets:
international
assets of China
are still
dominated by
foreign
currencies, 34%
of china's
external debt are
priced in the
RMB.**

**Overseas products
and services
purchased by
international
currency:
Constantly Increasing
international
acceptance of RMB.**

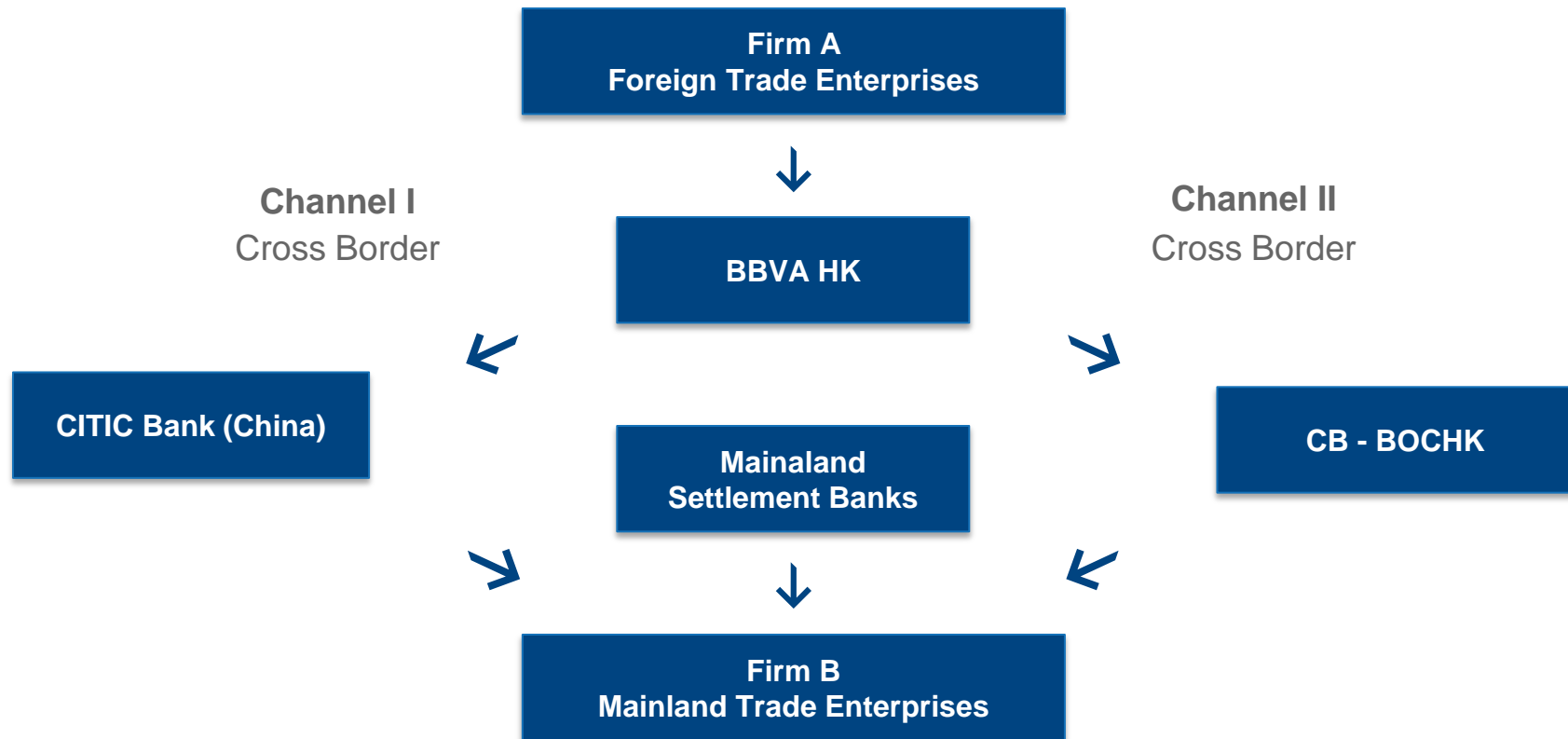
**Facilitating
financial reform:
financial reform is
ongoing but
unfortunately still
not completed.**

02

**Strategies to
increase overseas
usage of RMB**

Step I: RMB cross-border trade settlement program

TWO CHANNELS FOR RMB TRADE SETTLEMENT



Source: BBVA Research

The first strategic step of RMB internationalization was introduced in July 2009 (four cities and one provinces), it has significantly expanded in June 2010 (20 provinces) and became nationwide in August 2011.

Step II: Developing offshore RMB centers

Increasing the use of overseas RMB channels through a limited opening capital account.

Hong Kong as the premier offshore RMB center (offshore RMB deposit and Dim Sum Bond).

Limited opening of capital account (RMB, QFII and RMB FDI).

Step III: Signing bilateral currency swap agreements with other countries

Country / Economy	Amount	Effective Date	Expiration Date	Status	Amount	Effective Date	Expiration Date
China-Korea	180 bn RMB/38 Tr Won	Dec-08	Dec-11	Renewed	360 bn RMB/64 tr won	Oct-14	Oct-17
				Renewed	360 bn RMB/64 tr won	Oct-17	Oct-20
China-Hong Kong	200 bn RMB/227 bn HKD	Jan-09	Jan-12	Renewed and expanded	400 bn RMB/490 bn HKD	Nov-11	Nov-14
				Renewed	400 bn RMB/505 bn HKD	Nov-14	Nov-17
				Renewed	400 bn RMB/470 bn HKD	Nov-17	Nov-20
China-Malaysia	80 bn RMB/40 bn MYR	Feb-09	Feb-12	Renewed and expanded	180 bn RMB/90 bn MYR	Feb-12	Feb-15
				Renewed	180 bn RMB/110 bn MYR	Aug-15	Aug-18
				Renewed	180 bn RMB/110 bn MYR	Aug-18	Aug-21
China-Belarus	20 bn RMB/8 tr BYB	Mar-09	Mar-12	Renewed	7 bn RMB/16 trn BYB	May-15	May-18
China-Indonesia	100 bn RMB/ 175 tr IDR	Mar-09	Mar-12	Renewed	7 bn RMB/2.22 bn BYB	May-18	May-21
				Renewed	100 bn RMB/ 175 tr IDR	Oct-13	Oct-16
China-Argentina	70 bn RMB/ 38 bn ARS	Mar-09	Mar-12	Renewed and expanded	100 bn RMB/ 175 tr IDR	Nov-18	Nov-21
				Renewed	70bn RMB/ 90 bn ARS	Jul-14	Jul-17
China-Iceland	3.5 bn RMB/66 bn ISK	Jun-10	Jun-13	Renewed and expanded	70bn RMB/ 175 bn ARS	Jul-17	Jul-20
				Renewed	3.5 bn RMB/66 bn ISK	Sep-13	Sep-16
China-Singapore	150 bn RMB/30 bn SGD	Jul-10	Jul-13	Renewed and expanded	3.5 bn RMB/66 bn ISK	Dec-16	Dec-19
				Renewed	300 bn RMB/60 bn SGD	Mar-13	Mar-16
				Renewed	301 bn RMB/64 bn SGD	Mar-16	Mar-19
China-New Zealand	25 bn RMB	Apr-11	Apr-14	Renewed	300 bn RMB/61 bn SGD	May-19	May-22
				Renewed	25 bn RMB/5 bn NZD	Aug-14	Aug-17
China-Uzbekistan	0.7 bn RMB	40644	14-Apr		26 bn RMB/5 bn NZD	May-17	May-20
China-Mongolia	5 bn RMB	May-11	May-14	Expanded	10 bn RMB/4.5 tn Mongolian Tugrik	May-14	May-17
				Expanded	15bn RMB/5.4 tn Mongolian Tugrik	Jul-17	Jul-20
China-Kazakhstan	7 bn RMB	Jun-11	Jun-14	Renewed	7 bn RMB/2200 billion KZT	Dec-14	Dec-17
China-Thailand	70 bn RMB/ 320 bn THB	Dec-11	Dec-14	Renewed	7 bn RMB/350 billion KZT	May-18	May-21
				Renewed	69 bn RMB/ 370 bn THB	Dec-14	Dec-17
				Renewed	70 bn RMB/ 370 bn THB	Jan-18	Jan-21
				Renewed	70 bn RMB/ 370 bn THB	Jan-18	Jan-21

Step III: Signing bilateral currency swap agreements with other countries(2)

Country / Economy	Amount	Effective Date	Expiration Date	Status	Amount	Effective Date	Expiration Date
China-UAE	35 bn RMB/20 bn AED	Jan-12	Jan-15	Renewed and expanded	20 bn RMB/351 billion PKR	May-18	May-21
China-Turkey	10 bn RMB/3 bn TRY	Feb-12	Feb-15	Renewed	35 bn RMB/20 bn AED	Dec-15	Dec-18
China-Australia	200 bn RMB/30 bn AUD	Mar-12	Mar-15	Renewed and expanded	12 bn RMB/5 bn TRY	Nov-15	Nov-18
China-Ukraine	15 bn RMB/19 bn UAH	Jun-12	Jun-15	Renewed	199 bn RMB/40 bn AUD	Mar-15	Mar-18
China-Brazil	190 bn RMB/60 bn BRL	41346	16-Mar	Renewed	200 bn RMB/40 bn AUD	Apr-18	Apr-21
China-UK	200 bn RMB/20 bn GBP	Jun-13	Jun-16	Renewed	15 bn RMB/62 bn UAH	Dec-18	Dec-21
China-Hungary	10 bn RMB/375 bn HUF	Sep-13	Sep-16	Renewed	200 bn RMB/20 bn GBP	Oct-15	Oct-18
China-Albania	2 bn RMB/3.58 bn ALL	Sep-13	Sep-16	Renewed	200 bn RMB/20 bn GBP	Oct-18	Oct-21
China-ECB	350 bn RMB/45 bn EUR	Oct-13	Oct-16	Renewed	10 bn RMB/416 bn HUF	Sep-16	Sep-19
				Renewed	2 bn RMB/34.2 bn ALL	Apr-18	Apr-21
				Renewed	350 bn RMB/45 bn EUR	Oct-16	Oct-19
				Renewed	351 bn RMB/45 bn EUR	Oct-19	Oct-22
China-Switzerland	150 bn RMB/21 bn CHF	Jul-14	Jun-17	Renewed	150 bn RMB/21 bn CHF	Jul-17	Jul-20
China-Sri Lanka	10 bn RMB/225 bn Rupee	Sep-14	Sep-17				
China-Russia	150 bn RMB/815 bn Rupee	Oct-14	Oct-17				
China-Qatar	35 bn RMB/20.8 bn Rials	Nov-14	Nov-17				
China-Canada	200 bn RMB/30 bn Cad	Nov-14	Nov-17				
China-Armenia	1 bn RMB/77 bn Armenian dollars	Mar-15	Mar-18				
China-Suriname	1 bn RMB/520 mn Surinamese dollar	Mar-15	Mar-18				
China-South Africa	30 bn RMB/54 bn South African Rand	Apr-15	Apr-18	Renewed	30 bn RMB/54 bn South African Rand	Apr-18	Apr-21
China-Chile	22 bn RMB/2200 bn CLP	May-15	May-18	Renewed	22 bn RMB/2200 bn CLP	May-18	May-21
China-Tajikistan	3 bn RMB/3 bn Somoni	Sep-15	Sep-18				
China-Morocco	10 bn RMB/15 bn Moroccan Dirhams	May-16	May-19				
China-Serbia	1.5 bn RMB/27 bn Serbian Dinars	Jun-16	Sep-19				
China-Egypt	18 bn RMB/47 bn Egyptian Pounds	Dec-16	Dec-19				
China-Nigeria	15 bn RMB/720 bn NGN	Apr-18	Apr-21				
China-Macao	30bn RMB/35 bn Patacas	Dec-19	Dec-22				

Two BBVA research about the RMB currency swap

GARCIA-HERRERO & XIA (2013)

- The geographical distance of China (gravity model) → RMB regionalization before internationalization.
- Trade relation China matters but not investment relation.
- China does not especially favor the countries with weak institutions.
- China does not mind the BSA partners' history of sovereign defaults and their inconvertibility of capital account (pull factors).

SONG & XIA (2019)

- Signing of BSAs helped to promote China's trade with other countries.

The actual use of currency swaps is not still rare.

Why enterprises are willing to participate in the RMB internationalization?

THE BENEFITS AND THE COSTS OF THE PILOT PROGRAM

Participants	Advantage (or benefit)	Disadvantages (costs)
Domestics TFs (Domestic Exporters and Importers)	<ul style="list-style-type: none"> ■ Eliminate Exchange rate risk. ■ Reduce the cost from foreign currency Exchange and related hedge (2-3%). ■ Simplify the procedures of export. ■ Other benefits from the governments' measures to encourage RMB settlement. 	<ul style="list-style-type: none"> ■ Relative higher cost for trade finance. ■ Subject to various quota controls set up by PBoC.
Overseas TFs (Mainly Overseas Exporters)	<ul style="list-style-type: none"> ■ Strong appreciation expectation of RMB. ■ Higher yield from the growing offshore RMB financial product market. ■ No Exchange risk if permitted to invest the offshore RMB back into China as FDI. 	<ul style="list-style-type: none"> ■ Inconvertibility of RMB under the capital account (inflow of offshore RMB approved on a case-by-case basis). ■ Small and illiquid offshore RMB market.
Multinational Enterprises with operations in China	<p>Besides all the above advantages, MNEs can also leverage the interest and Exchange rate differentials between the onshore and offshore RMB market to maximize its profitability.</p>	

Source: CBI & BBVA Research

RMB settlement helps enterprises to better manage their risk exposure to the exchange rate.

Business Opportunities for Banks

THE BUSINESS OPPORTUNITIES DERIVED BY THE RMB OVERSEAS SETTLEMENTS

Business Scope

Details

Participant Banks (PB)

Provide cross-border RMB trade settlement services for trading firms including trade settlement and trade finance.

Retail and Corporate Banking

Provide offshore RMB services for corporates or individuals such as deposit-taking, currency exchange, remittance, checking and RMB loans.

Investment Banking

Provide equity listing, bond issuance, international asset management and hedging services to enterprises in the mainland.

Source: CBI and BBVA Research

The RMB internationalization has brought related business opportunities to banks.

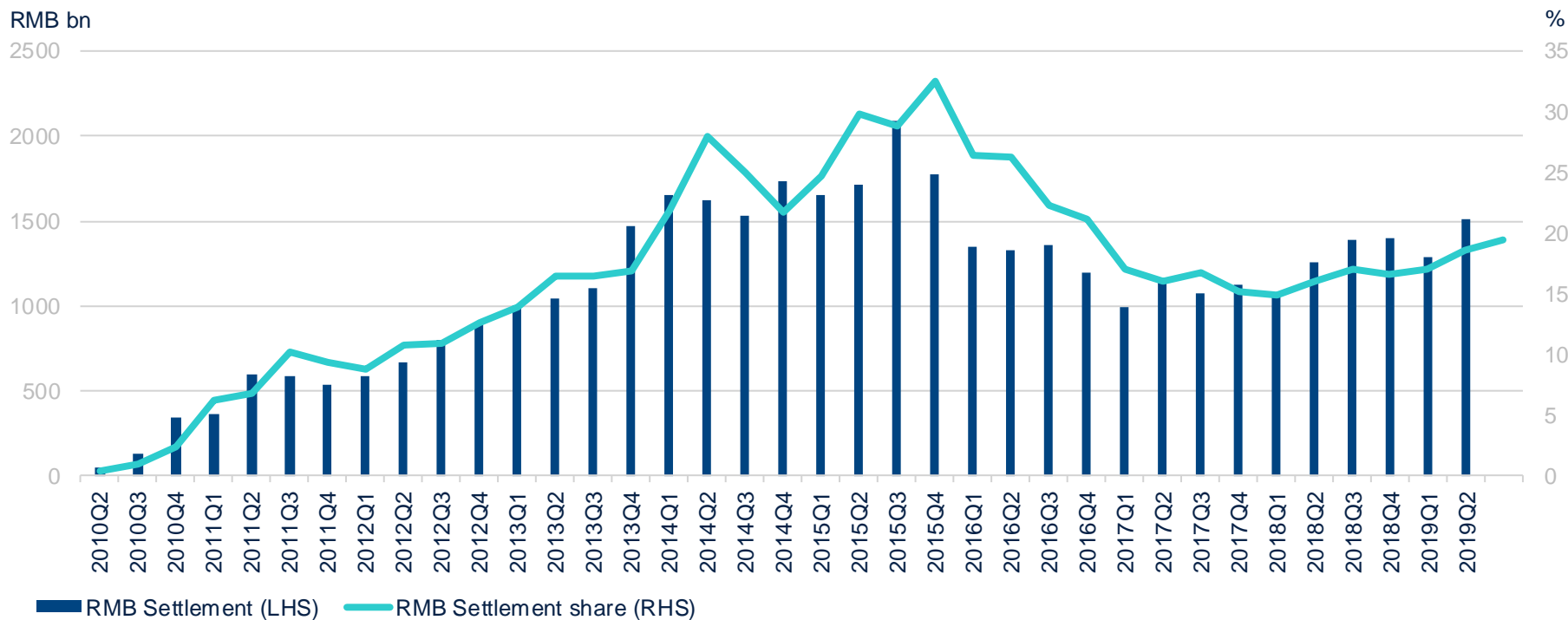
In the offshore RMB center, banks can benefit from increasingly diversified RMB products.

03

Taking stock of early fruits

RMB denomination in cross-border trade

GENERALLY, THE PERCENTAGE OF RMB SETTLED TRADE HAS INCREASED STEADILY



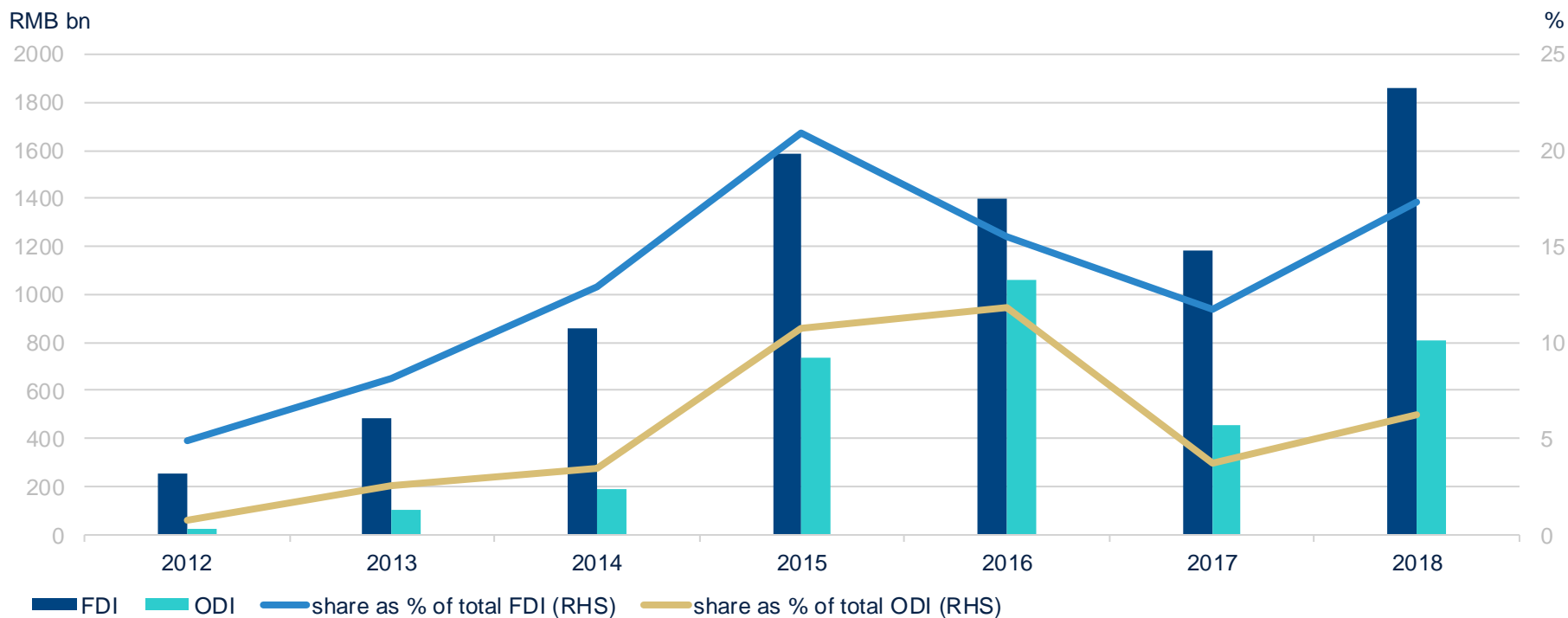
Source: CEIC & BBVA Research

Source: CEIC & BBVA Research

Trade settled in RMB started to soften after a fast rise through Q3 2015.

RMB denominated FDI

THE SHARE OF RMB DENOMINATED FDI INCREASED



Source: SAFE, CEIC & BBVA Research

RMB denominated FDI flows have increased gradually over the past years.

High ranking of global trading volume

CURRENCY DISTRIBUTION OF OTC FOREIGN EXCHANGE TURNOVER (NET-NET BASIS, 1 PERCENTAGE SHARES OF AVERAGE DAILY TURNOVER IN APRIL²)

Currency	2004		2007		2010		2013		2016		2019	
	Share	Rank	Share	Rank	Share	Rank	Share	Rank	Share	Rank	Share	Rank
USD	88.0	1	85.6	1	84.9	1	87.0	1	87.6	1	88.3	1
EUR	37.4	2	37.0	2	39.0	2	33.4	2	31.4	2	32.3	2
JPY	20.8	3	17.2	3	19.0	3	23.0	3	21.6	3	16.8	3
GBP	16.5	4	14.9	4	12.9	4	11.8	4	12.8	4	12.8	4
AUD	6.0	6	6.6	6	7.6	5	8.6	5	6.9	5	6.8	5
CAD	4.2	7	4.3	7	5.3	7	4.6	7	5.1	6	5.0	6
CHF	6.0	5	6.8	5	6.3	6	5.2	6	4.8	7	5.0	7
CNY ³	0.1	29	0.5	20	0.9	17	2.2	9	4.0	8	4.3	8
HKD ³	1.8	9	2.7	8	2.4	8	1.4	13	1.7	13	3.5	9
NZD ³	1.1	13	1.9	11	1.6	10	2.0	10	2.1	10	2.1	10
SEK	2.2	8	2.7	9	2.2	9	1.8	11	2.2	9	2.0	11
KRW ³	1.1	11	1.2	14	1.5	11	1.2	17	1.7	15	2.0	12
SGD ³	0.9	14	1.2	13	1.4	12	1.4	15	1.8	12	1.8	13
NOK ³	1.4	10	2.1	10	1.3	13	1.4	14	1.7	14	1.8	14
MXN ³	1.1	12	1.3	12	1.3	14	2.5	8	1.9	11	1.7	15
INR ³	0.3	20	0.7	19	0.9	15	1.0	20	1.1	18	1.7	16
RUB ³	0.6	17	0.7	18	0.9	16	1.6	12	1.1	17	1.1	17

Source: BIS 2019 3-year survey & BBVA Research

Compared with the size of China's economy, the RMB trading volume is still underwhelmed.

RMB enters into other countries' foreign exchange reserves

IMF COFFER database started to report RMB's share in global foreign reserves in 2019.

WORLD CURRENCY COMPOSITION OF OFFICIAL FOREIGN EXCHANGE RESERVES

(US DOLLARS, MILLIONS)

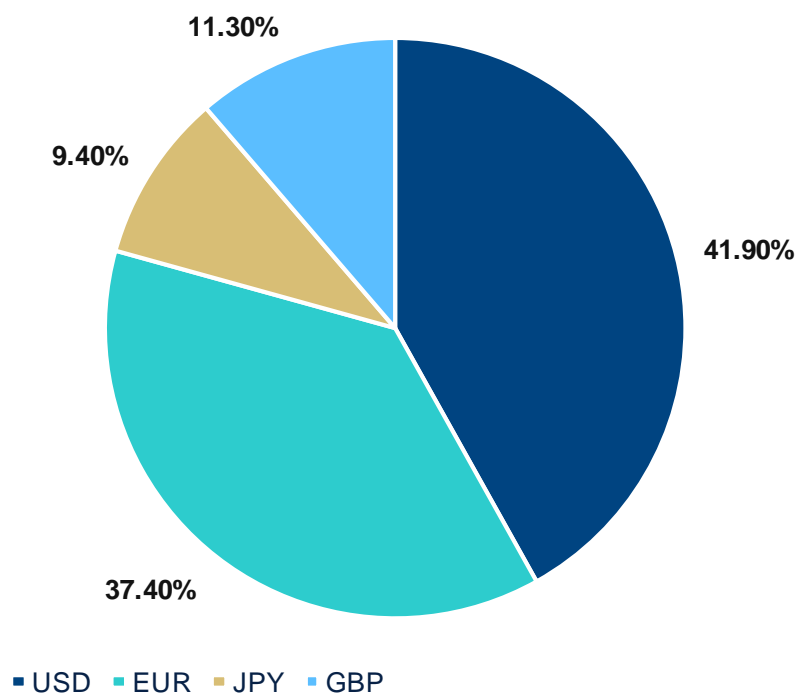
	2018Q2	2018Q3	2018Q4	2019Q1	2019Q2
Total Foreign Exchange Reserves	11481336.46	11411176.60	11435818.52	11607014.65	11732569.03
Allocated Reserves	10515275.81	10707901.60	10728215.17	10899006.27	11021225.42
Claims in U.S. dollars	6561092.78	6631625.37	6623362.69	6742183.62	6792225.70
Claims in euros	2129348.13	2192128.19	2217371.63	2205243.40	2242712.88
Claims in Chinese renminbi	192750.33	192635.82	202869.19	212694.85	217643.88
Claims in Japanese yen	511517.74	532569.37	557646.99	571700.41	596609.72
Claims in pounds sterling	469863.68	480734.01	474166.47	494419.38	488561.28
Claims in Australian dollars	178610.50	180605.40	173951.72	182476.14	187572.04
Claims in Canadian dollars	200214.51	208725.91	197216.33	209249.10	211057.43
Claims in Swiss francs	17180.81	17170.11	15294.50	15282.34	15808.79
Claims in other currencies	254697.35	271707.41	266335.65	265757.03	269033.71
Unallocated Reserves	966060.64	703275.00	707603.34	708008.38	711343.61

Source: IMF & BBVA Research

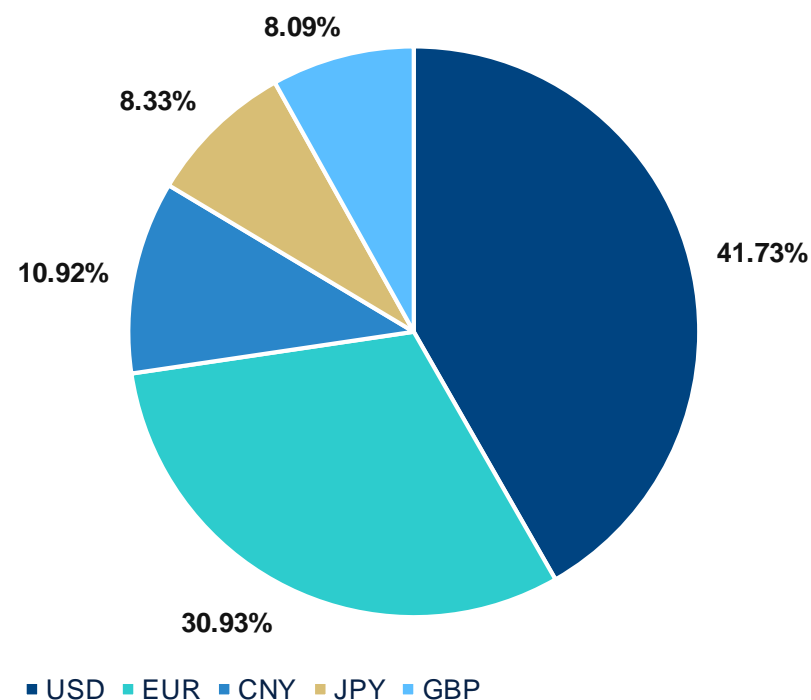
More and more countries and economies have announced the inclusion of the yuan in foreign exchange reserves. The ECB has included certain RMB assets into its foreign exchange reserves (June 2017).

RMB joined SDR in 2015

THE INTERNATIONAL STATUS OF THE RMB IS ENDORSED BY THE IMF



Source: BBVA Research

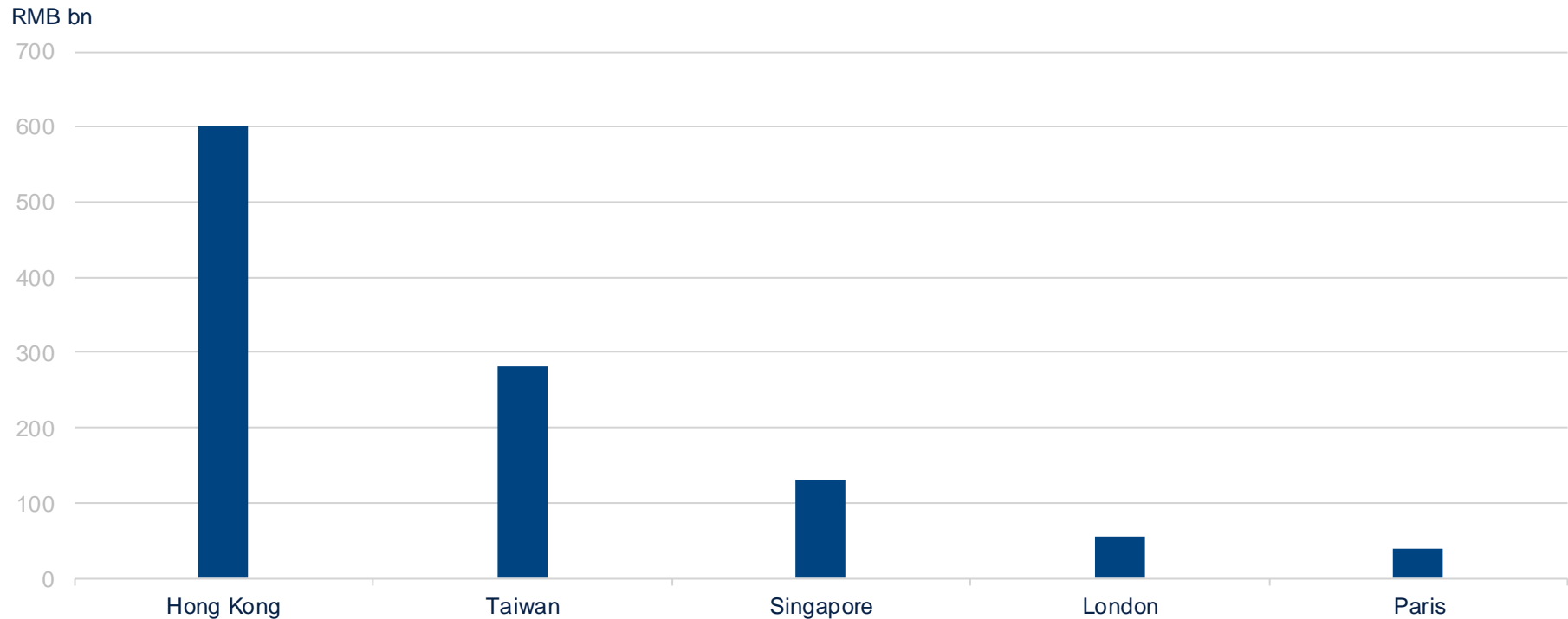


Source: CEIC & BBVA Research

IMF share reform provides an opportunity for the RMB to join SDR. The RMB grabs the share of the Euro.

RMB offshore financial centers

HONG KONG HAS THE LARGEST VOLUME OF OFFSHORE RMB DEPOSITS (AS OF MAR-2019)

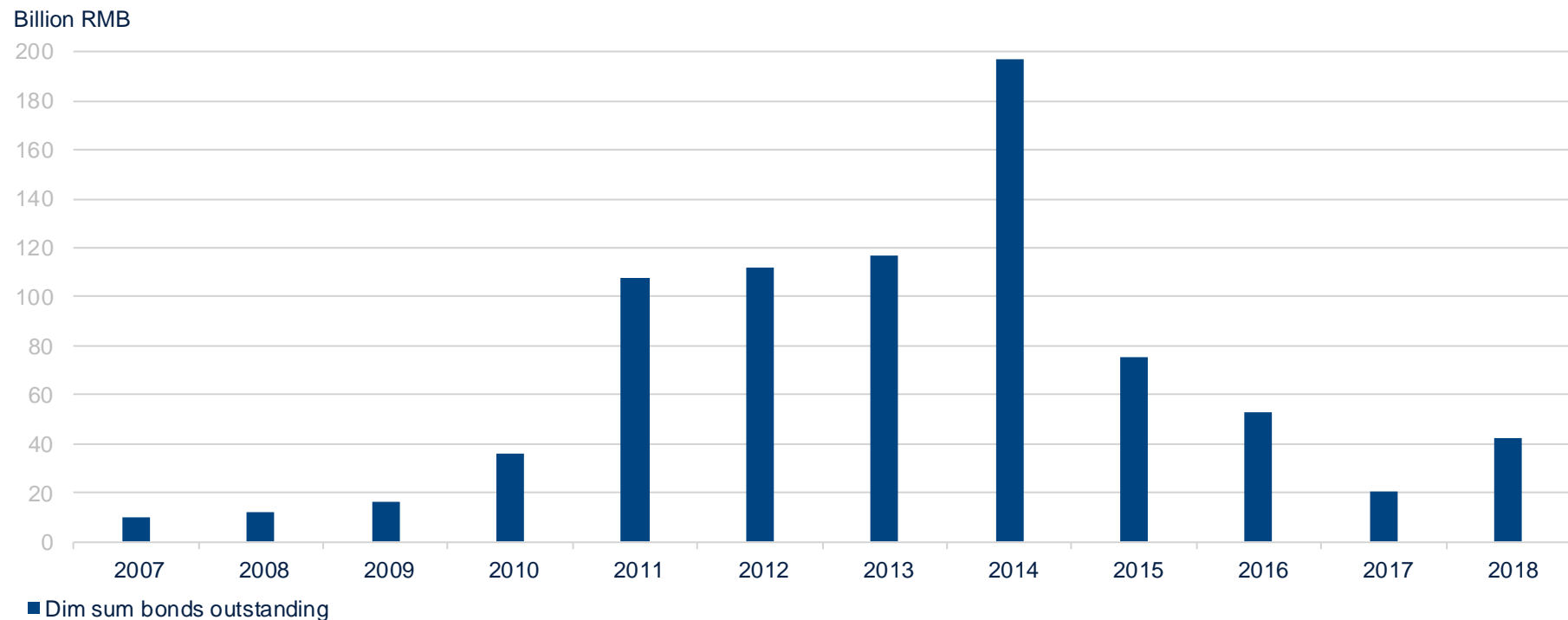


Source: Media reports, Bloomberg & BBVA Research

Hong Kong remains the largest RMB offshore market, while other cities are catching up.

Dim Sum Bond market in Hong Kong

HONG KONG DIM SUM BOND MARKET

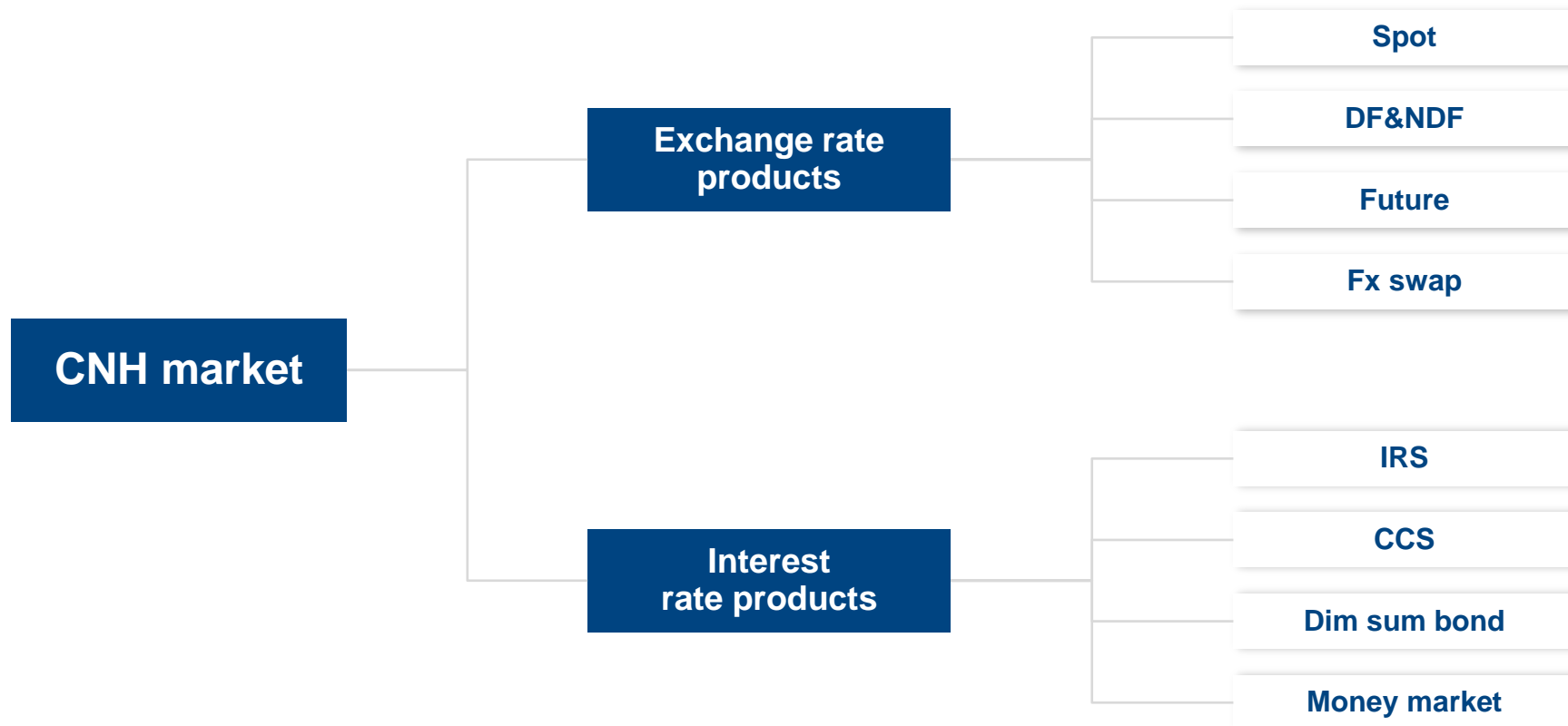


Source: Media reports, Bloomberg & BBVA Research

Dim Sum bond is the RMB denominated bonds issued in Hong Kong.

An offshore RMB market is taking shape

THE RMB PRODUCTS OF HONG KONG OFFSHORE RMB MARKET

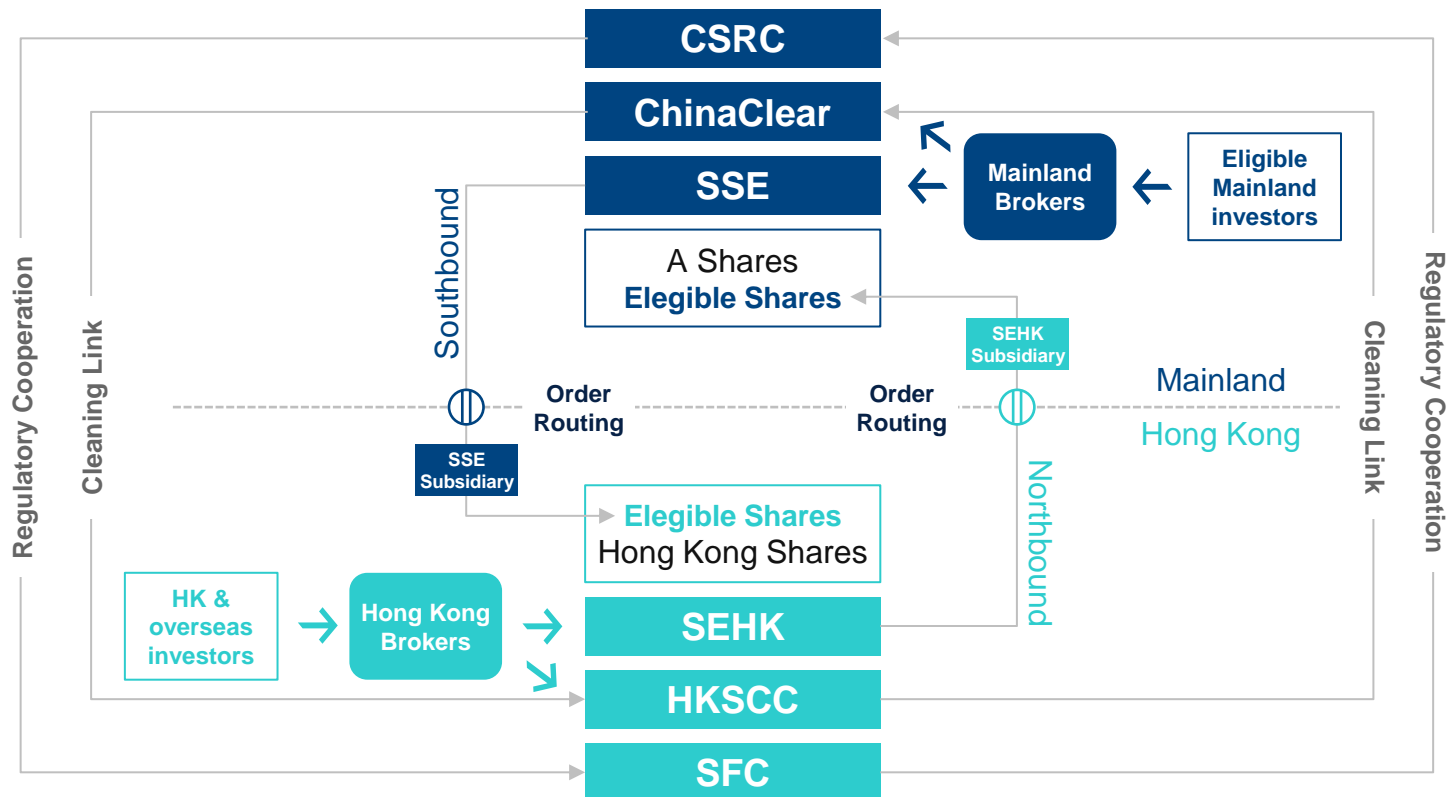


Source: BBVA Research

The trading volume of CNH market exceeds that of the domestic market.

RMB internationalization promotes the opening of China's stock market

“SHANGHAI-HONG KONG STOCK TRADING” CHART



Source: Hong Kong Stock Exchange & BBVA Research

“Shanghai-Hong Kong stock connection” and “Shenzhen-Hong Kong stock connection” are a milestone of capital account opening too. Under this situation, investor in Hong Kong can purchase stock in Shanghai, and vice versa.

Two new channels for overseas investors to invest in China's bond market

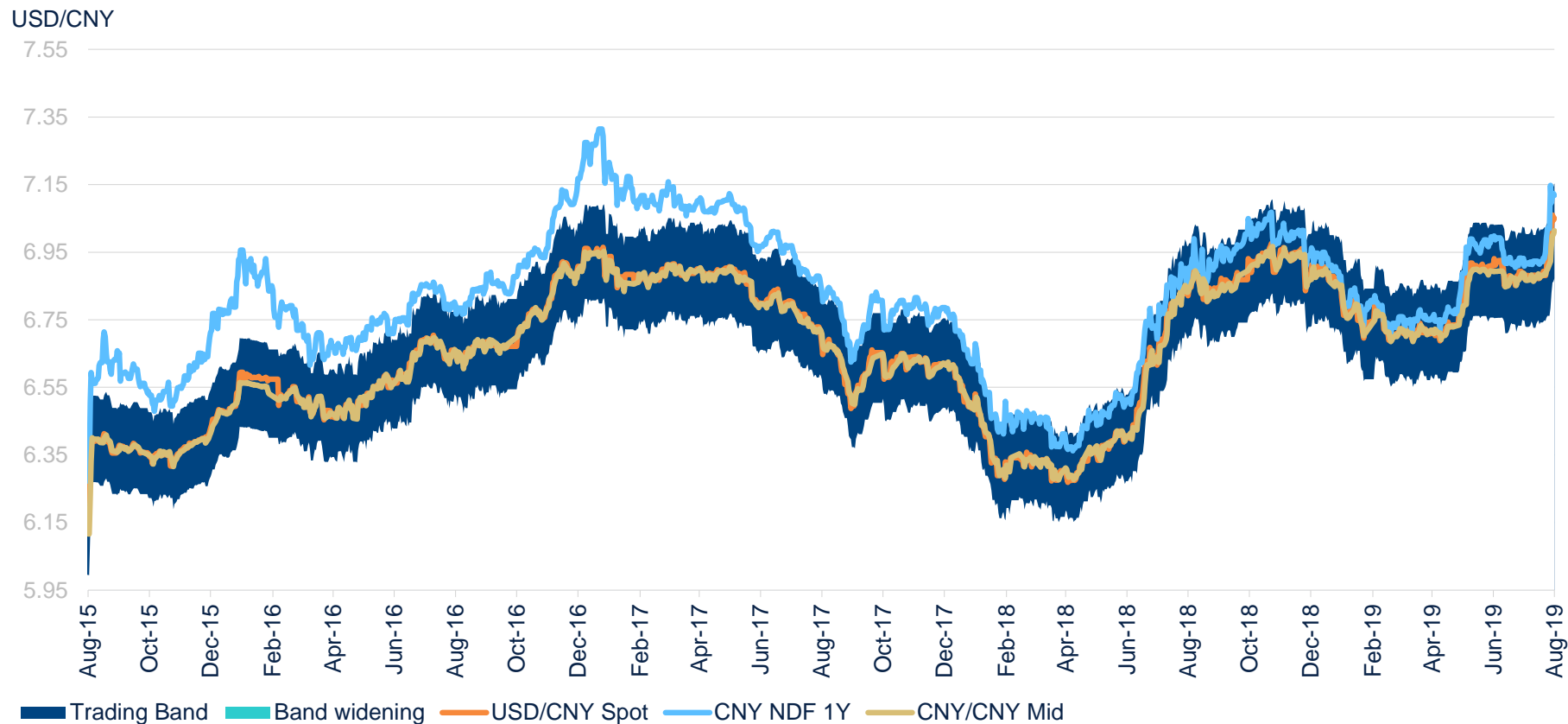


04

“811”

**devaluation
and its
implication**

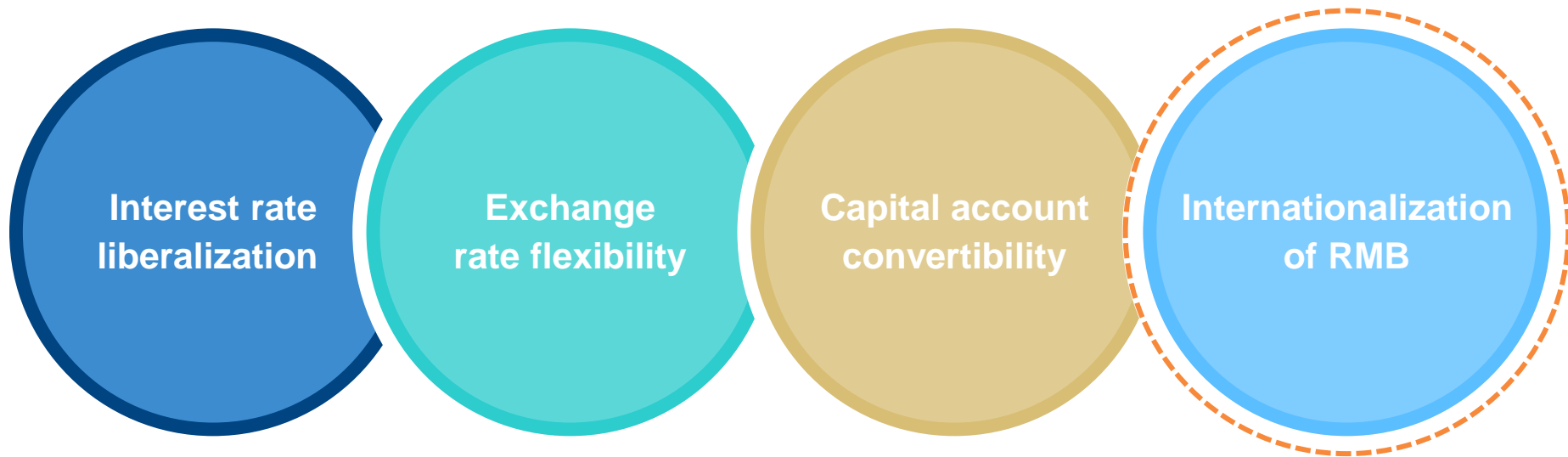
The exchange rate plumped after the 8.11 exchange reform



Source: CEIC & BBVA Research

The exchange rate plumped before recovered after the 8.11 exchange reform.

RMB internationalization as an element of financial reform



RMB internationalization precedes capital account and exchange rate liberalization → sequencing issue of financial reforms.

Theories of sequencing issue in financial reform

Johnston, Darbar and Echevarria (1997) , capital account liberalization should proceed in coordination with reforms in monetary policy and exchange rate.

Sheng (2009) revisits Asian financial crisis and point out that the main culprit is the pegged exchange rate amidst capital account opening.

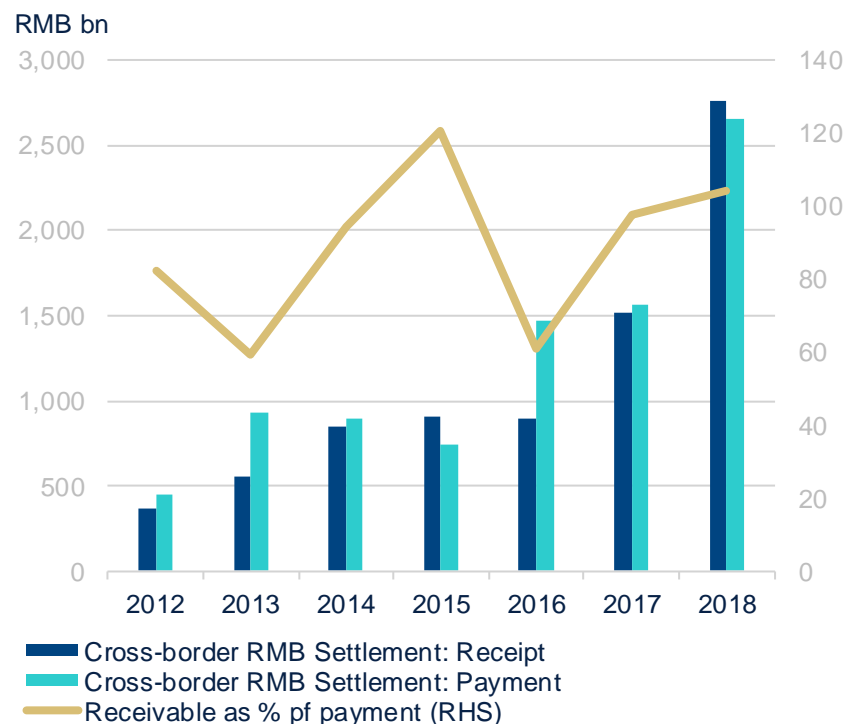
Prasad, Rumbaugh and Wang (2005) , Cappiello and Ferrucci (2008): China should liberalize exchange rate before opening its capital account.

Yu (2013): The RMB internationalization in essence generates new loopholes on the porous capital account.

Our view: It is possible to push forward the exchange rate reform, capital account opening and RMB internationalization hand-in-hand under certain circumstance. However, the sequencing issue could backfire when the conditions change.

Internationalization brings uncertainty to exchange rate reform (I)

CHANGES IN THE RMB PAYMENT RATIO



RMB internationalization means a net outflow of RMB

Net outflow of three forms:

01

Trade settlement

02

Foreign investment

03

Residents RMB usage in other countries

Source: CBRIC & BBVA Research

Strong depreciation could lead overseas RMB to flow back to the onshore market, resulting in a decline in foreign exchange reserves and a pressure on the onshore market exchange rate.

Internationalization brings uncertainty to exchange rate reform (II)

PRE AND POST 811 THE EXCHANGE OF SIMPLE GRANGER CAUSALITY TEST RESULTS

		Regress CNY on CNH (lag=8)	Regress CNH on CNY (lag=8)
--	--	----------------------------------	----------------------------------

Before the August 11 Reform	F-statistic significance level	3.335 0.0008***	3.798 0.0002***
-----------------------------	--------------------------------	--------------------	--------------------

Before the August 11 Reform	F-statistic significance level	6.986 0.000***	1.322 0.2279
-----------------------------	--------------------------------	-------------------	-----------------

Notes: *** means F-test is significant at 1% level; no * means it is not significant at 1%, 5% or 10% level.

Interaction between RMB offshore market and onshore market

Offshore market guides the onshore market after currency reform since people tend to think that offshore market has less intervention

The offshore market can not reflect the net supply of foreign exchange caused by China's trade surplus.

Government response

Overseas RMB return → closed capital account, intervention in the fx market.

Offshore and onshore market → intervention through offshore branches of Chinese banks. The cost is excessive volatility of offshore interest rate.

BSA → more caution in signing new ones.

Lesson and experience that “811” reform gives us

- The order of China's financial reform.
- Compared with the internationalization of the RMB, subject to other factors (domestic financial stability), exchange rate reform is a task that with higher priority.
- The future deployment of the RMB internationalization strategy needs to consider the exchange rate tolerance (emphasis on overseas RMB return and offshore market issues).
- For example, the free flow of RMB under open separately capital is not feasible.
- A relatively closed RMB cross-border circulation system may be safer (The Belt and Road Initiative).
- Related to the offshore and onshore market, The main battlefield of RMB internationalization moved to the onshore market.
- The long-term future of RMB currency swap (return to traditional function).

Source: FSB & BBVA Research

The current exchange rate is also the most important constraint to the internationalization of the RMB.

05

**Next breakthrough:
The opening-up
of RMB
bond market**

External challenges and opportunities of RMB Internationalization



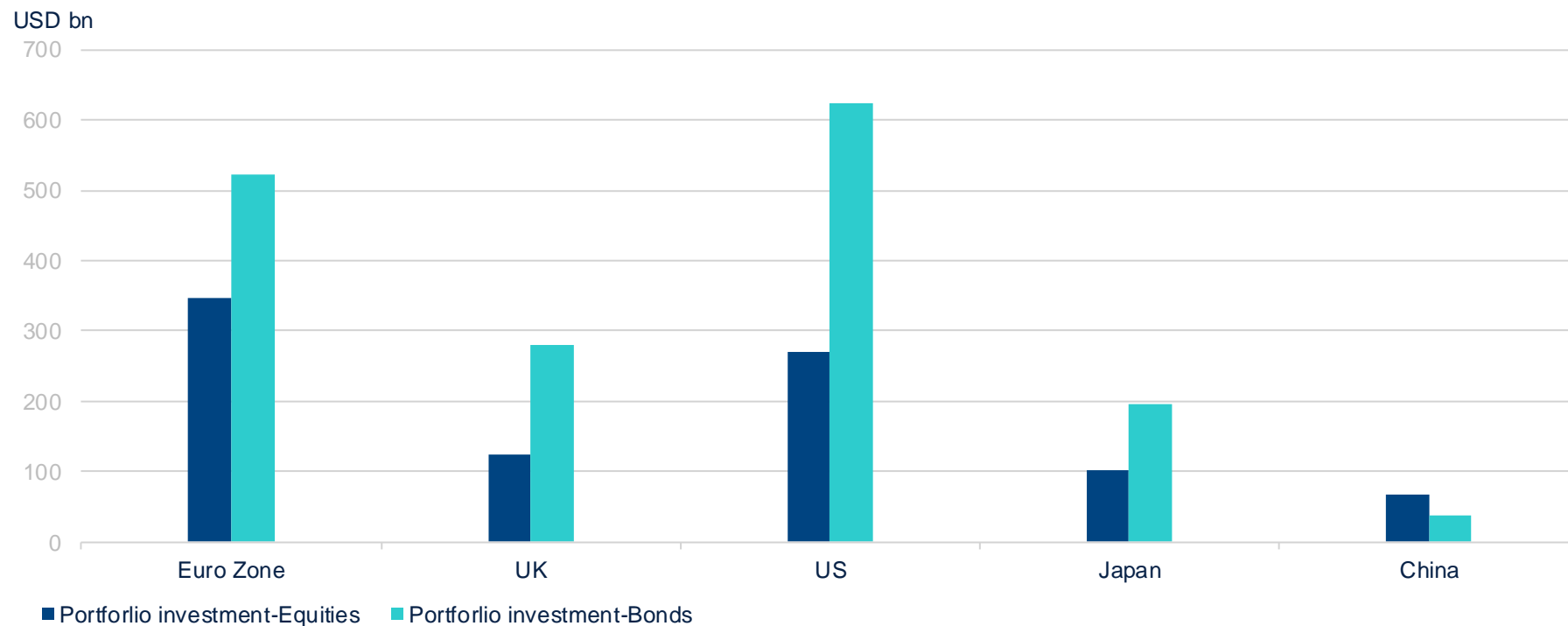
Source: CBRIC & BBVA Research

The next step of the RMB Internationalization will be focus on enhancing the RMB's function of financial transactions: the opening of the domestic bond market could be a breakthrough. Overcome the "Triffin dilemma": RMB internationalization under condition of trade surplus.

The bond market as one main channel for international capital flow

COMPARISON OF BOND CAPITAL FLOWS AND EQUITY CAPITAL FLOW

(1999-2018)



Source: BIS & BBVA Research

“Safe Asset”.

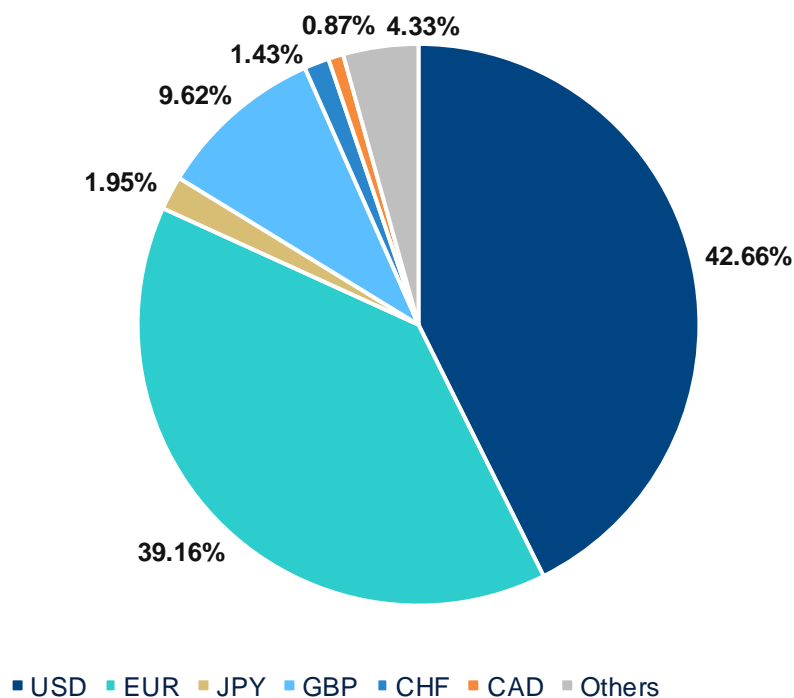
The exception is China.

The underlying assets of QII/QDII programs were equity.

Allow the QFII and RQFII programs to invest in bond markets.

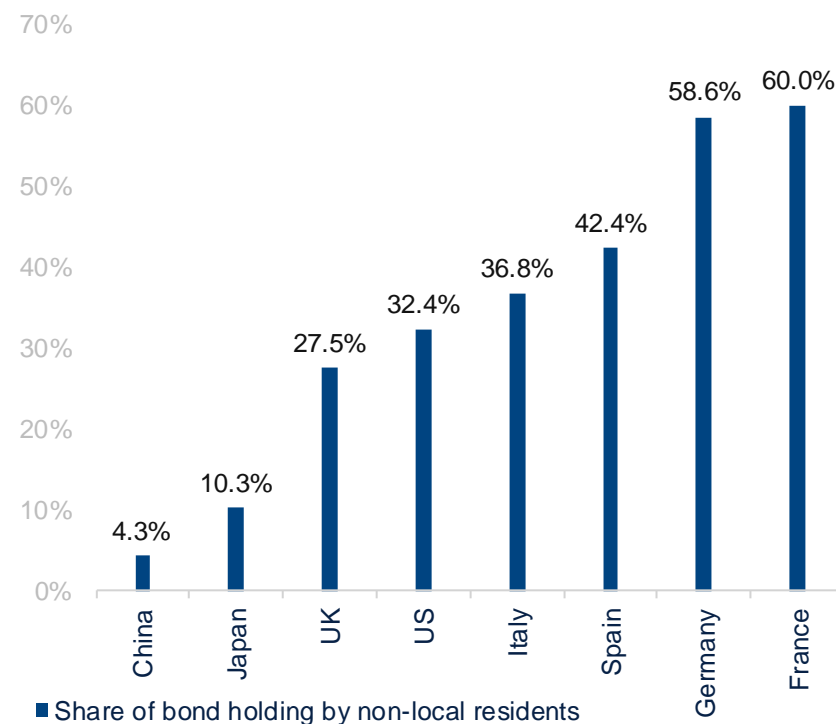
International currencies' role in financial transactions

INTERNATIONAL BOND MARKET PRICE CURRENCY SHARE (2015)



Source: BIS & BBVA Research

NON-RESIDENT INVESTMENT IN SOVEREIGN BONDS



Source: Bruegel, ADB, Wind & BBVA Research

The six major international currencies accounted for >95% of the outstanding international bonds. Other major economies, including the US(32.4%), UK(27.5%), Japan (10.3%) tend to have higher shares of sovereign bonds held by non-residents than China (4.3%).

Optimizing the framework of monetary policy and improving bond market liquidity



The gap between China and other countries in their bond market liquidity

- The turnover of China's government bonds in 2016 is **only 1.3 times**, which is much lower than that of the developed countries, such as in **the U.S. 36, Canada 19, the U.K. 17, and Japan 16.**



Banks prefer buy-and-hold than frequent bond trading due to the excessively volatile short-term market rates

- According to some PBoC research, China's overnight SHIBOR volatility is about 2-4 times to the volatility of the US, Japan, South Korea and India's overnight interest rate.



Accelerating the establishment of interest rate corridor system as the new monetary policy framework

- The central bank intends to establish an interest rate corridor with the upper limit of the short-term lending facility (SLF) rate and the excess reserve rate as the lower limit.
- The central bank frequently uses open market operations to control the inter-bank 7-day repo rate within the interest rate corridors as a policy interest rate.

Channels to strengthen the financial trading function in the RMB bond sector

Bond Issuer	Bond Investor	Onshore Market	Offshore Market
Residents	Residents	<p>(1)</p> <p>Nature: Domestic Bond</p> <p>Activities: Domestic bond investors buy the bonds in the interbank and exchange markets</p>	<p>(5)</p> <p>Nature: Eurobond</p> <p>Activities: Residents issue Dim Sum Bonds and RMB Formosa Bonds in the offshore market; the residents buy the bonds through the QDII, QDLP and other capital open projects in the offshore market</p>
	Non-Residents	<p>(2)</p> <p>Nature: Domestic Bond</p> <p>Activities: Foreign residents buy bonds issued by residents through the opening-up project of the QFII, RQFII, QFLP, inter-bank market open and other capital markets.</p>	<p>(6)</p> <p>Nature: Eurobond</p> <p>Activities: Residents issue Dim Sum Bonds and RMB Formosa Bonds in the offshore market; foreign residents buy the bonds in the offshore market</p>
Non-Residents	Residents	<p>(3)</p> <p>Nature: Foreign Bond</p> <p>Activities: Non- residents issue panda bond; residents buy the bond</p>	<p>(7)</p> <p>Nature: Eurobond</p> <p>Activities: Foreign Residents issue Dim Sum Bond and RMB Formosa Bond in the offshore market; the residents buy the bonds through the QDII, QDLP and other capital open projects in the offshore market</p>
	Non-residents	<p>(4)</p> <p>Nature: Foreign Bond</p> <p>Activities: Non- residents issue panda bond; the non-residents buy the bonds through the QFII, QDLP, opening-up of inter-bank and open projects in other capital markets</p>	<p>(8)</p> <p>Nature: Eurobond</p> <p>Activities: Foreign residents Dim Sum Bond and RMB Formosa Bond in the offshore market; the foreign residents buy the bonds in the offshore market</p>

Emphasize on the financial function of treasury bonds



**Increase the supply
of short-term
treasury bonds.**



**Improve the market
maker system of the
secondary market.**



**Fine-tune the tax
policy of the
Treasury bonds.**



Enhancing the liquidity of the bond market

Establish a unified regulatory framework

MULTIPLE REGULATORS

- Blurred boundary of the regulatory division.
- Regulatory overlap.
- Different regulatory standards.
- Competition among regulators (race to the bottom?).
- Bond market segmentation.
- Impeding the bond market's function of allocating resources.



**Gradually
change**



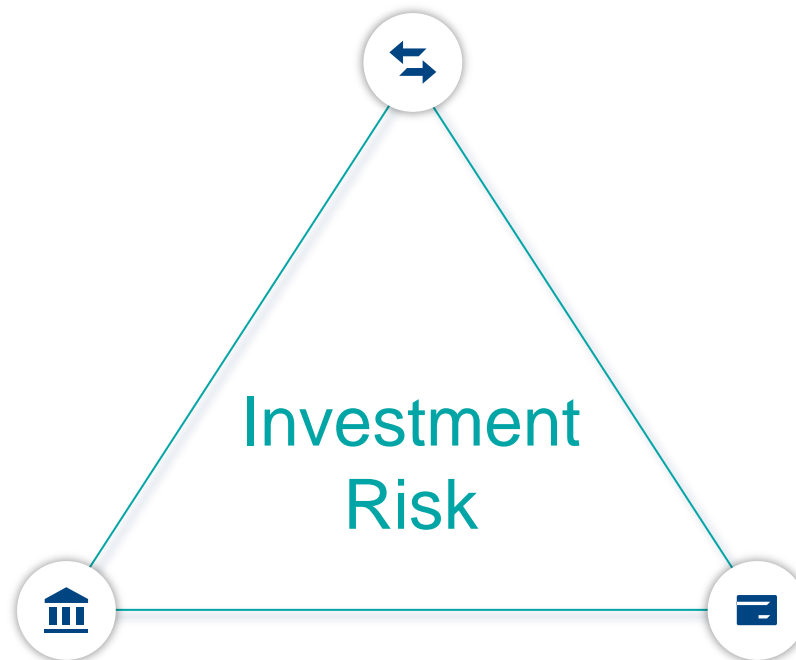
UNIFIED REGULATORY FRAMEWORK

- Improve the efficiency of supervision.
- Unified interconnection of the bond custody system.
- Promote the development of OTC market.
- Free transfer between the inter-bank and exchange bond markets.
- NO implicit guarantee.
- Adopting functional and penetration supervision.

Enriching risk management tools and Developing the bond derivatives market

Exchange Rate Risk

gradually allowing all overseas investors to trade foreign exchange derivatives through their clearing agents.



Interest rate Risk

Introducing futures of treasury bonds to the inter-bank market.

Credit Risk

Introducing and developing the credit default swap (CDS) market.

Disclaimer

This document has been prepared by BBVA Research Department. It is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

Any estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

With regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions on the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

The content of this document is protected by intellectual property laws. Reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process is prohibited, except in cases where it is legally permitted or expressly authorised by BBVA.

This report has been produced by:

Chief Economist

Le Xia

Le.xia@bbva.com

Betty Huang

betty.huang@bbva.com