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RMB internationalization:

London's potential from Hong Kong's perspective

Alicia Garcia-Herrero

Chief Economist for Emerging Markets, BBVA

Chatham House and Central Policy Unit Hong Kong SAR

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Key points

1 Why is China pushing to internationalize the RMB?

2 Is HK enough?

3 London’s potential role

1. Why is China pushing to internationalize the RMB?

Two possible – and yet opposed - reasons:

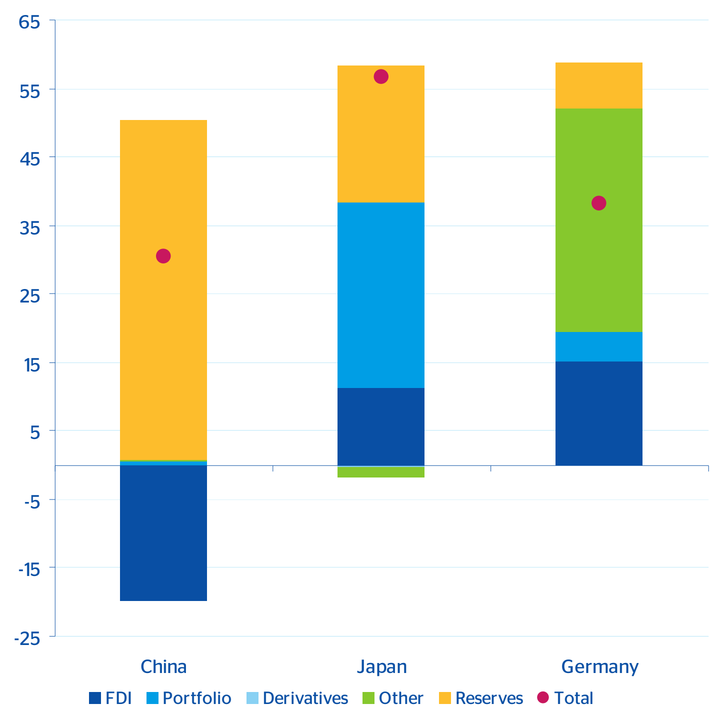
A. The external creditor/diversification story

B. Net debtor story (longer term)

1. Why is China pushing to internationalize the RMB?

A. China as huge external creditor

International Investment Position 2010 (% of GDP)
Source: BBVA Research and IMF



1. Why is China pushing to internationalize the RMB?

With all its external wealth in foreign currency, **diversification needed.**

Two ways

1. Diversifying the currency holdings away from USD and Euro
   too difficult

2. RENMINBISING China's foreign assets may be easier
   - How much would be enough?
     - Probably more similar to Japan than the US.
       - About 12% of holdings of Japanese debt securities are in yen vs 90% for US ones in USD
       - Still China has a long way to go: starting basically from 0%!

1. Why is China pushing to internationalize the RMB?

B. China becoming a net debtor

Why should China become a net debtor?

1. Aging and increasing pension/health costs
2. Potential costs of a bank bailout in the event of a hard landing (stemming from the accumulation on loans to LGFVs/developers/etc)

China interested in accessing the “exorbitant privilege of having a reserve currency” to finance its growing debt

2. Is HK enough? Certainly not

- Hong Kong cannot absorb global demand for RMB
- Risk to financial stability (bank liquidity and currency mismatches)
  - Development of onshore market crucial
  - Meanwhile development of other offshore centers also relevant

Possible choices (probably all)

- Singapore
- London
- Taipei
- New York

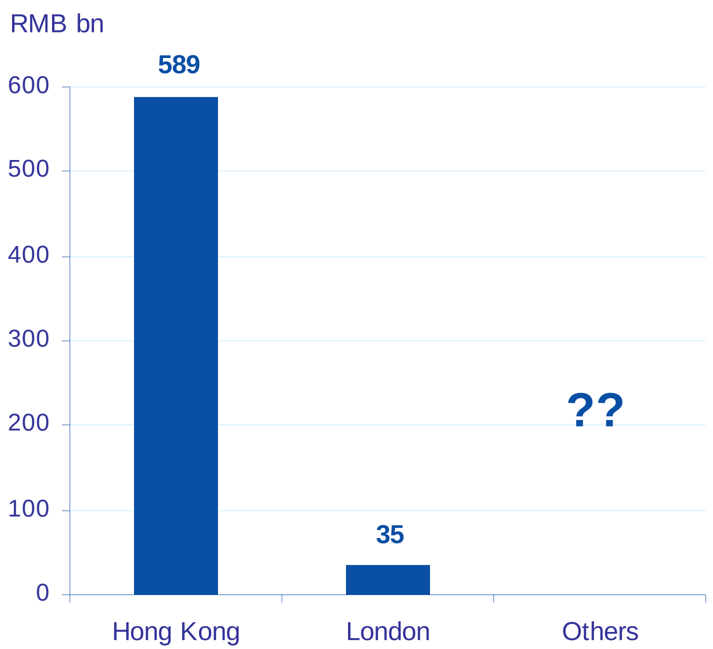
3. London's role?

Where are Offshore RMB deposits?

London bigger than people think (direct channel/no custodian)

Offshore RMB deposits by the end of 2011 (RMB bn)

Source: CEIC and BBVA Research

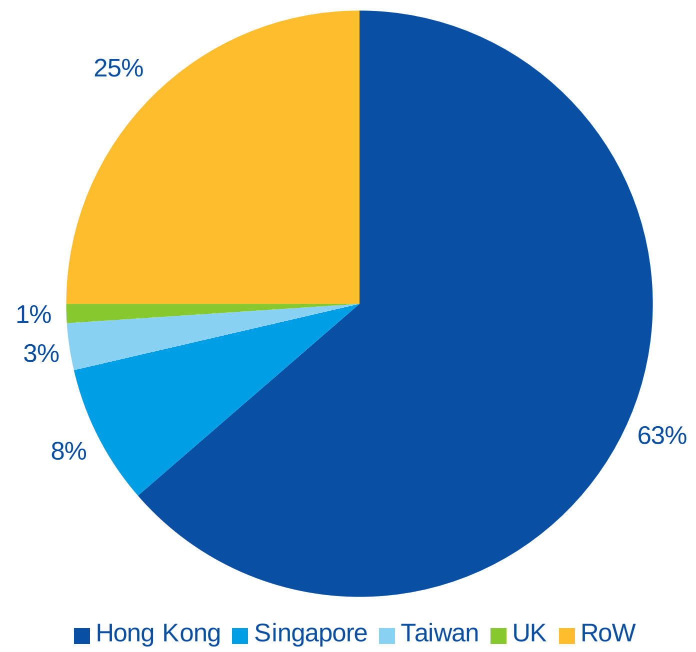


Note: Figures reported in the chart of are customer deposit. London reported in December 2011 that the total RMB deposit is RMB 109 bn, which also both customer deposits and interbank deposits. We do not have a comparable figure for Hong Kong.

3. London's role?

But London still hardly relevant for RMB cross-border settlement. Is it all speculative?

RMB cross-border settlement (as at Jan 2012)
Source: PBoC and BBVA Research



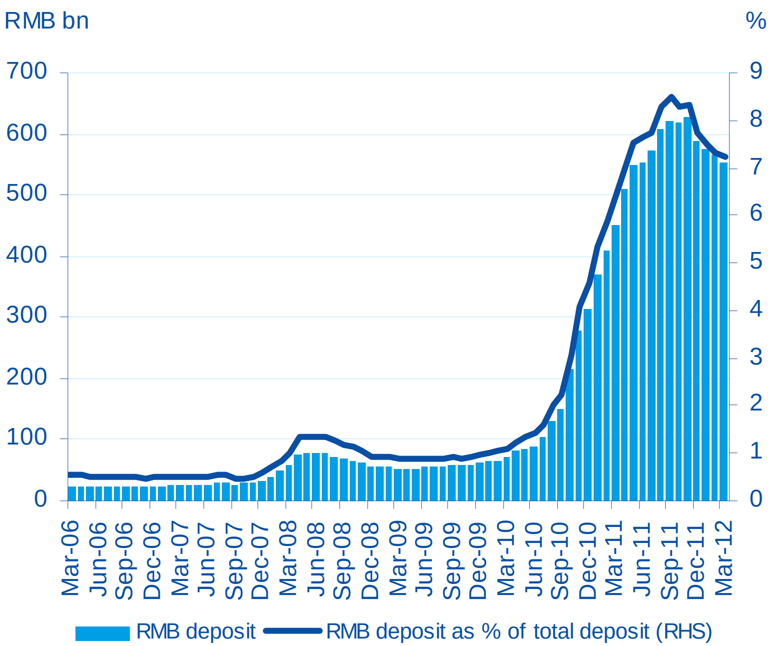
Divergence of Deposits/RMB settlements

Potential reasons:

- More foreign importers participate in RMB trade settlement by paying RMB back to China (20% of total RMB trade to around 50%)
- Lower appreciation expectation (how is this affecting London)?
- Easier repatriation of offshore RMB under capital account (RQFII, RMB FDI): Is this helping HK?
- Diversion of other RMB offshore centers??

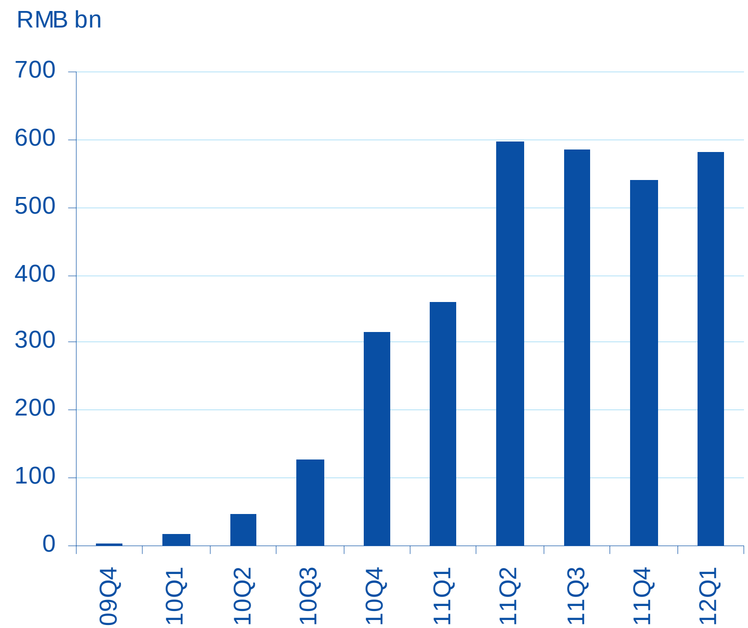
RMB deposits in Hong Kong are declining

Source: HKMA, CEIC and BBVA Research



Value of RMB settlement rebounded in Q1 2012

Source: PBoC and BBVA Research



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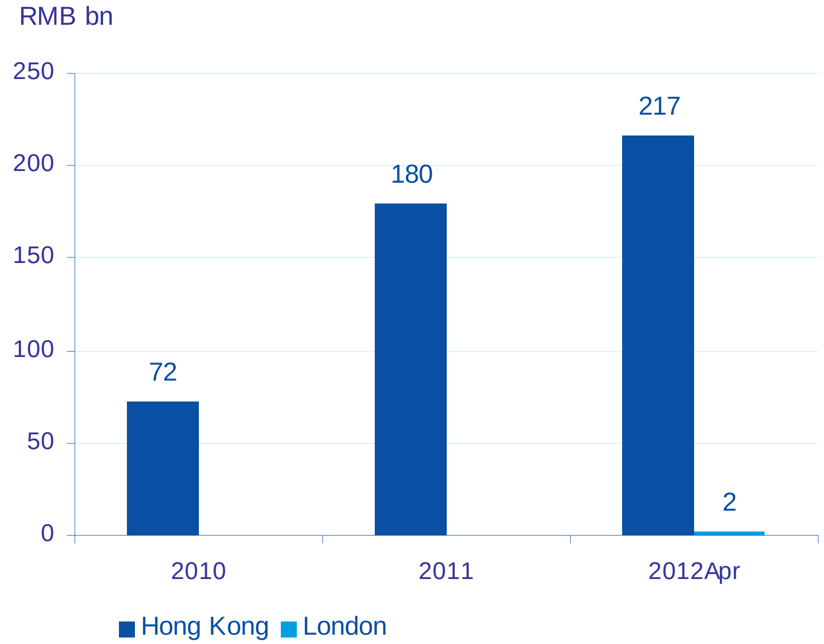
3. London's role in offshore RMB bond issuance

Still at its infancy but more chances than other centers given liquidity issues, including NDF market

Offshore RMB bond outstanding (ytd)

Source: HKMA and BBVA Research



4. Conclusions

- China is going to continue with this process, specially now that capital inflows are not an issue (if not outflows!)
- HK is not large enough to cover the needs – and should not even try
- There is room for others including London
- No real direct competition given the size of the market

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Comments welcome

Alicia Garcia-Herrero (alicia.garcia-herrero@bbva.com)