Interest rate strategy

CNH: "Q" expansion heralds next stage of capital account liberalisation

DBS Group Research

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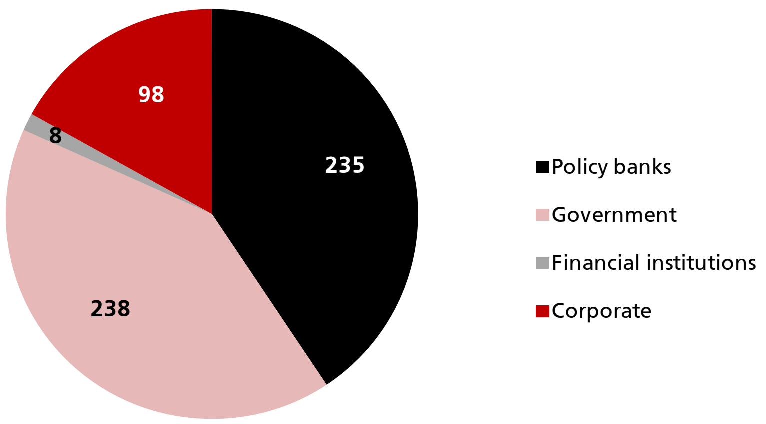
- **China has approved 32 foreign institutions to invest in its bond market**
- **Ample room remains for further expansion since foreigners' current bond holdings account for only about 2% of the total**
- **To avoid offshore liquidity shrinkage, authorities will guide increased yuan outflow**

In recent days, China has approved 32 foreign institutions to invest in its domestic bond market worth USD 5.9 tn, mainly via the QFII (Qualified Foreign Institutional Investor) and RQFII (Renminbi Qualified Foreign Institutional Investor) schemes. This "Q-expansion" is part of Beijing's long-term commitment to open China's capital account, towards which momentum continues to build (see "CNH: To break fresh ground in 2015", 17 Nov 2014). Table 1 summarizes the recent developments.

QFII and RQFII are the two major channels through which to access the onshore capital market (both stocks and bonds). Although the QFII program has grown slowly since its inception in 2002, it received a significant boost last year from rapid and sizable approvals. Meanwhile, the quota on the much newer RQFII program, which was launched in late 2011, has quickly increased to a sizable RMB 360 bn. Prior to the latest approvals, 268 QFIIs and 121 RQFIIs had been approved. Offshore institutions currently hold RMB 579 bn (USD 93 bn) in interbank bonds as of Mar15, up 44% YoY (Chart 1).

Chart 1: China bond holding by offshore entities (RMB bn)



Note: excludes exchange-traded bonds

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Table 1: Recent developments on China's capital account opening

Program	Launched	Details
Qualified Foreign Institutional Investor (QFII) Scheme	2002	USD 73.6bn had been approved as of April 2015, up 35.3% YoY. According to Hong Kong's financial secretary, Hong Kong will work with Mainland authorities to further increase the city's RQFII quota.
Qualified Domestic Institutional Investor (QDII) Scheme	2006	USD 90bn had been approved as of April 2015, up 12.5% YoY.
Renminbi QFII (RQFII) Scheme	2011	In March 2015, China's SAFE tripled Fidelity's investment quota for accessing China's capital markets. RMB 363.7bn had been approved as of April 2015, up 68.7% YoY.
China Shanghai Pilot Free Trade Zone (FTZ)	Sep 2013	The FTZ spans approximately 29 square km. It is intended to be a test bed for capital account liberalization. In Feb 2014, the PBoC allowed companies based in the FTZ to conduct offshore RMB borrowing. Two-way cross-border RMB cash pooling - which allows foreign investors to transfer funds between their onshore entities and overseas entities - was also allowed. In Feb 2015, new rules allowed companies in the FTZ to raise money in both local and foreign currencies in offshore capital markets.
Shanghai-Hong Kong Stock Connect	Nov 2014	Investors in Hong Kong and Mainland China can trade shares listed on each other's market The Northbound and Southbound total investment quota is set at RMB 300bn and RMB 250bn respectively. The daily quota is set at RMB 13bn and RMB 10.5bn respectively.
FTZs in Guangdong, Fujian and Tianjin	Apr 2015	The zones are modelled after the Shanghai FTZ, and each would have a unique role. Guangdong FTZ would focus on cooperation with Hong Kong and Macau; Fujian FTZ would strengthen relationships with Taiwan; Tianjin FTZ would support the development of the Beijing-Tianjin-Hebei economic zone.
Shenzhen-Hong Kong Stock Connect	Possibly in 2015	Xiao Gang, chairman of the China Securities Regulatory Commission, said in March that preparations for the Shenzhen-Hong Kong Stock Connect were under way.

In addition to financial institutions, the yuan is being held by more central banks since last year

Ongoing capital account liberalization has lifted the popularity of the yuan which is increasingly being held by not only financial institutions but by a growing number of central banks as well. In particular, the UK last year raised RMB 3 bn via the landmark issuance of an offshore sovereign yuan bond. The proceeds were held as foreign reserves rather than converted into dollars or euros. The ECB has also laid the groundwork to add yuan to its forex reserves. Australia's central bank has acknowledged a 3% allocation of its forex reserves to yuan. To date, more than 50 central banks, sovereign institutions, and supranationals have invested in yuan either through QFII / RQFII schemes, the China Interbank Bond Market (CIBM), or offshore CNH markets. Such investment will only accelerate when the yuan becomes part of the IMF's Special Drawing Rights (SDR), which seems likely to occur this year (see "CNH: Going abroad", 10 Dec 2014).

Challenges

As more public and private investors add yuan to their portfolios, pressure will grow on Beijing to speed up financial market reforms. Going forward, poli-

More policies will address challenges such as market fragmentation, insufficient information disclosure, and the lack of a properly-functioning yield curve

cies will need to address challenges such as market fragmentation, insufficient information disclosure, and the absence of properly-functioning yield curve. Developing a deep and liquid bond market is key to a more efficient allocation of capital. Specifically, a fully-functioning bond market enables banks to increase their lending to households and SMEs. Yet, the current development of the China's bond market does not match the country's economic strength. Bond market capitalization amount to only around 50% of China's GDP; roughly one-third as high as in the US. Meanwhile, it is not practical for the yuan to become a reserve currency if foreigners' bond holdings count for only 2% of domestic bond holdings. Hence, if the yuan to continue growing as a reserve currency, further access to domestic markets is needed.

Fewer yuan offshore?

China will further expand cross-border investment channels for mainland individual investors

In the short-run, however, more inflows into onshore instruments – through avenues such as RQFII, the Shanghai-Hong Kong Stock Connect and the anticipated Shenzhen-Hong Kong Stock Connect – may mean tighter offshore liquidity pool. Broadening channels of yuan supply to the offshore market is needed to achieve more balanced flows between Hong Kong and China over the longer-term. In a statement at the 31st meeting of the International Monetary and Financial Committee held in Washington in April, the PBoC's governor Zhou Xiaochuan said that China will further expand cross-border investment channels for individual investors, such as via the pilot program of Qualified Domestic Individual Investor. Apart from boosting offshore liquidity, such measures would help China achieve better balance between inflow and outflow (see "CNH: To break fresh ground in 2015", 17Nov14).

In short, for the yuan to become a more common and widely held reserve currency there needs to be greater access for foreign investors in domestic capital markets, a larger offshore yuan liquidity pool, and wider cross-border flow channels. All are developing more quickly than most envisioned just one or two years ago.

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