An Australian Government Initiative

Australian Financial Centre Task Force

RMB invoicing in a longer run context: opportunities and challenges for Australia[1]

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This paper sets the issue of RMB trade invoicing[2] in the broader context of the move over time towards internationalisation of the RMB. It then examines some of the opportunities and challenges for the Australian financial sector, both in this current early phase of RMB internationalisation and in a more medium term context, and outlines some of the market and policy issues that are likely to shape the extent to which Australia makes the most of the opportunities.

(a) Viewing Trade Invoicing in a Longer Run Context

A working definition of the internationalisation of a currency that has been suggested in the literature, and which may be useful in thinking about RMB internationalisation, is the following:

'A currency is internationalised when market participants — residents and non-residents alike — conveniently use it to trade, to invest, to borrow and to invoice in it outside the currency's home country' [3]

An internationalised currency thus fulfills all the usual roles of a domestic currency — a unit of account (such as for invoicing and denomination of financial products), a medium of exchange (such as for settlement of trade and financial transactions), and a store of value (such as for foreign exchange reserves and private savings) — but does so offshore as well as onshore.

Studies looking at the internationalisation of the USD and other currencies over the past century or so show the links between these various roles and how they typically develop over time. A recent IMF Working Paper summarised the usual process and requirements as follows:

'First, the size and breadth of the trade network (closely linked to economic size) and invoicing practices determine the demand for the currency as a unit of account and medium of exchange; second, macroeconomic stability and the currency's credibility/strength make it an attractive store of value, further fostering demand for it. The third requirement is on the supply side: depth and openness of financial markets and currency convertibility.' [4]

To date, at least outside of Hong Kong, China's internationalisation of the RMB has been mainly focused on trade invoicing and settlement. Since the expansion of the RMB trade settlement program in June 2010, official data imply that RMB-denominated trade settlement has grown substantially, accounting for 14 per cent of China's total foreign trade in the December quarter of 2012. However, its use — at least outside of Hong Kong — as a store of value has been very limited and substantially constrained, due to the exchange controls still in place.[5] The limited availability of RMB-denominated investment products outside of China and Hong Kong makes potential investors less willing to hold onto RMB, other than for short-term speculation around its appreciation. This in turn further limits the offshore build-up of RMB liquidity.

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2 While a distinction can be made between the invoicing currency and the currency in which a trade is settled, in this paper it is assumed that trades that are invoiced in RMB are also settled in RMB.

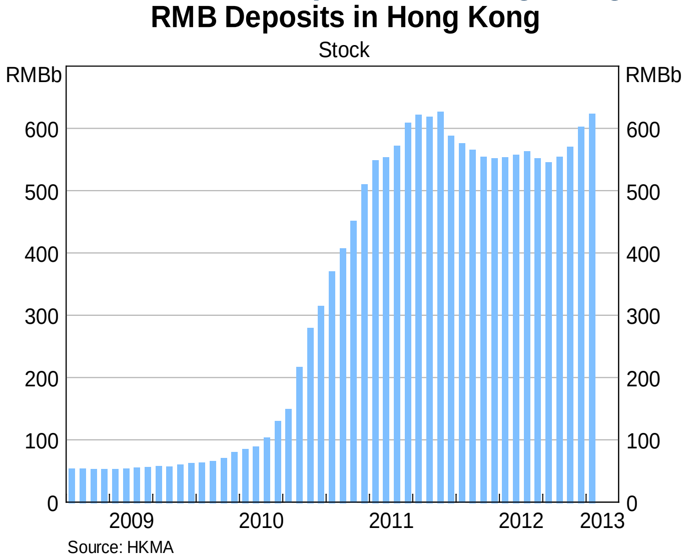
3 Robert McCauley, 'Renminbi Internationalisation and China's Financial Development', BIS Quarterly review, December 2011, p. 41

4 Samar Maziad and Joong Shik Kang ' RMB Internationalization: Onshore/Offshore links', IMF Working Paper WP/12/ 133, May 2012, p. 4

5 It is however worth noting that a number of central banks have already diversified their foreign exchange reserves to include RMB.

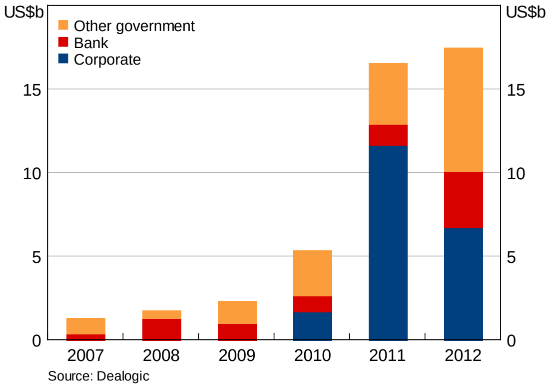
While the rapid build-up of offshore RMB deposits in recent years has occurred alongside a significant increase in the proportion of China's total trade that is invoiced in RMB, it also reflects expectations of RMB appreciation. When in the latter part of 2011 these expectations turned round, RMB deposits in Hong Kong actually contracted (see chart 1 below). This contraction may also have reflected Hong Kong investors diversifying away from RMB deposits into other RMB denominated financial assets; nonetheless, the episode does suggest there are limitations in relying primarily on trade invoicing and associated expectations of RMB appreciation — which may well change over time — for greater RMB internationalisation.

Chart 1: RMB deposits in Hong Kong



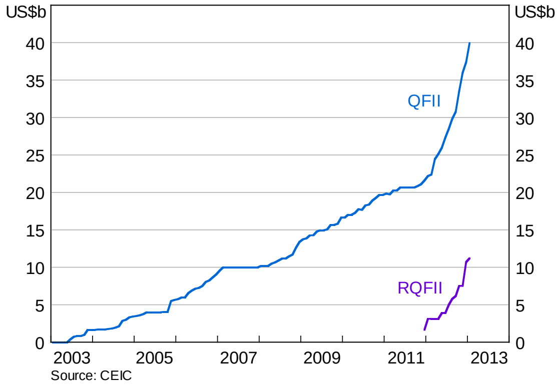
While RMB trade invoicing is a first major step in the path towards RMB internationalisation, Hong Kong provides a good example of the associated need for ongoing capital account liberalisation if the internationalisation process is to continue. Since 2003, Hong Kong residents have been able to buy limited amounts of RMB on a daily basis, with those limits having been increased over time; and since 2007 the sale of RMB denominated (Dim Sum) bonds has been permitted in Hong Kong and has grown rapidly, providing an investment alternative to bank accounts (chart 2 below). Access to onshore bond and equity markets has also been allowed in limited but increasing quotas (chart 3 below: QFII figures include quotas held outside of Hong Kong). In January 2013 it was announced that Hong Kong and China would negotiate a mutual recognition treaty to facilitate the sale of mutual funds across borders. These and other moves to relax capital controls between mainland China and Hong Kong have meant that, alongside the rapid growth in recent years of RMB trade invoicing between Hong Kong and China, the depth and breadth of broader RMB-related financial activity in Hong Kong has also grown substantially, providing both additional incentive and wider opportunities for holding RMB denominated assets.

Chart 2
Dim Sum Bond Issuance
By issuer



Source: Dealogic

Chart 3
Foreign Investment in Chinese Equities
Accumulated approved quotas, US dollar terms



Source: CEIC

In short, Hong Kong may be seen as the first example of the next stage of RMB internationalisation: that is, beyond a unit of account and medium of exchange to an offshore store of value.

Over time, should China choose to continue down the path of RMB internationalization, a similar approach will be necessary with respect to other offshore RMB centres and hubs[6], and eventually all overseas markets. This process has already begun, with Bank of China (Taipei) and ICBC (Singapore) very recently being granted RMB clearing bank licences for trade settlement purposes. It will be very interesting going forward to see if, as Singapore develops as a source of offshore RMB liquidity, capital controls between mainland China and Singapore are further eased.

The City of London is also holding ongoing discussions with China designed to facilitate its development as an offshore RMB centre. Paris is also actively engaged in discussions focused on the objective of making it a major European RMB hub.[7]

Domestically, the Chinese Government in 2011 announced its objectives for developing Shanghai as an international financial centre. Specific and ambitious targets have subsequently been set for 2015 in terms of trading volumes and other indicators. Achieving these targets will likely require further significant relaxation of capital controls, at least on a geographically limited 'pilot' basis. Development of Qianhai as an experimental zone focused on providing mechanisms for channeling offshore RMB back to mainland China and developing more innovative RMB financial services and investment products is also gathering momentum, with RMB 2 billion in loans to enterprises in the zone from Hong Kong domiciled banks approved in January 2013.

There are also links from ongoing RMB internationalisation back to ongoing reform of the financial markets in mainland China. There are two reasons for this. Firstly, if offshore investors are to view the RMB as a store of value over time, they will need increasing access to RMB financial assets in mainland China in which to invest and increasing confidence in those markets. A recent market review of the 2012 expansion of QFII and RQFII quotas

6 This paper draws on the useful distinction that has been used in some of the literature between an offshore RMB centre (currently primarily Hong Kong) and an offshore hub, with the latter connected to the onshore market indirectly through the offshore centre.

7 See Europlace, 'Paris Europlace Presents its Roadmap to Position Paris as a Major Corporate RMB Hub in Europe', press release, 30 November 2012.

concluded that, while very welcome, the greater challenge for China lay in 'structural reforms to increase the integrity and transparency of onshore markets.' [8]

Secondly, as over time more trade is invoiced in RMB and capital controls are further relaxed, the 'leakage' from the offshore RMB market to mainland China will increase, making it more difficult for the Chinese authorities to maintain effective control over interest rates, credit growth and credit allocation within mainland China. In order to avoid potentially destabilising flows associated with interest rate and exchange rate arbitrage opportunities, either the process of RMB internationalisation might need to be halted or the exchange rate and onshore interest rates might need to become more market determined. Reforms announced in the first half of 2012, doubling the daily range in which the RMB can move against the US dollar and allowing Chinese banks more flexibility in setting their interest rates relative to the official benchmark, were moves in the latter direction.

Already, even with only very narrow permitted channels connecting the offshore and onshore markets via such mechanisms as the QFII and RQFII programs and Hong Kong bond issuance by Chinese entities (see chart 4 below), a 2012 IMF Working Paper found evidence of spillover effects between the onshore and offshore markets.[9] In particular, their findings suggest that market volatility offshore has an impact on onshore volatility.

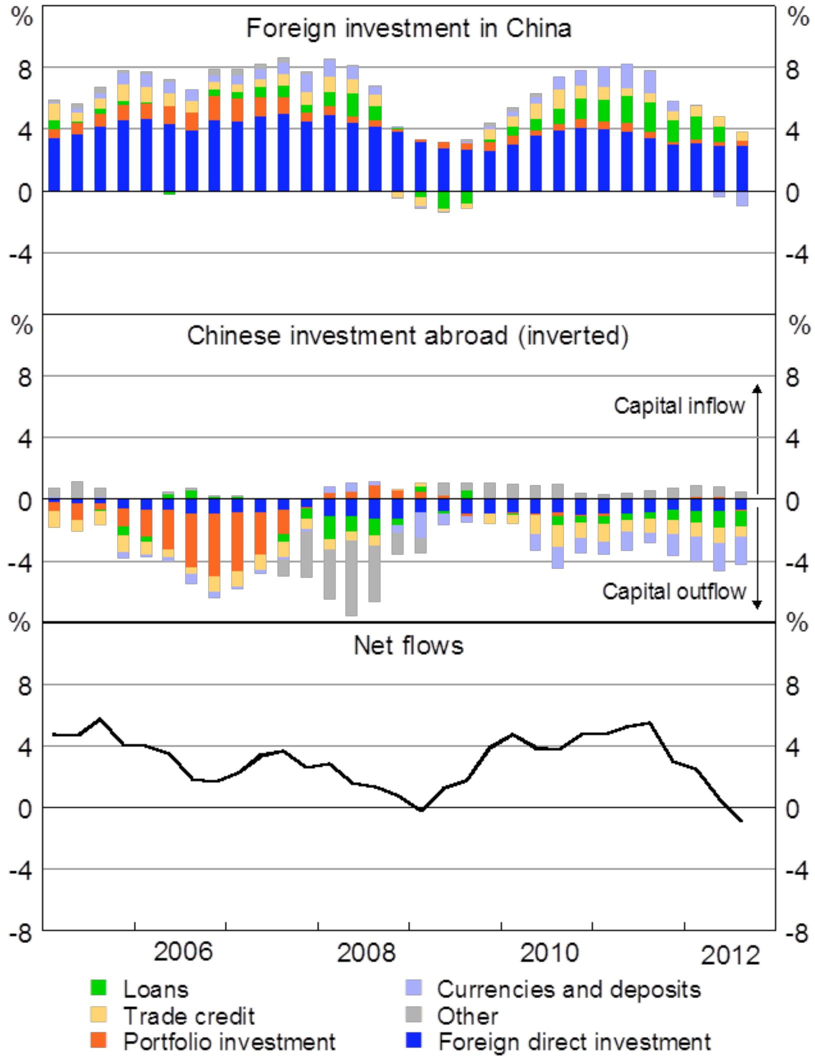
In short, over coming years the Chinese authorities will face a choice: they can continue with the move towards RMB internationalisation via increased trade invoicing and further relaxation of capital controls, which will also require increasing interest rate and exchange rate flexibility in order to keep control of domestic monetary policy; or they can halt the process of RMB internationalisation. To date, all the indications in terms of the pace of recent policy changes[10] are that the process is likely to continue and, if anything, could accelerate.

8 See 'China Refines QFII and RQFII to Broaden Appeal', Investment and Pensions Asia, January-February 2013, p.22.

9 Samar Maziad and Joong Shik Kang, op. cit.

10 Some examples of this are: the February 2013 announcements of an RMB clearing bank licence for trade settlement purposes being granted to ICBC (Singapore); the commencement in the same month of RMB clearing by Bank of China (Taipei); the November 2012 launch of a pilot program allowing companies to transfer RMB out of mainland China to their overseas parent company or other related companies; development of the Qianhai special economic zone; and the 2012 significant expansion in QFII quotas-easily the largest annual expansion- along with a more than doubling of RQFII quotas.

Chart 4
Private Capital Flows*
Per cent of GDP, rolling annual sum



* 'Private' flows are those unrelated to official reserve assets
Sources: CEIC; Thomson Reuters

(b) RMB Internationalisation: Challenges and Opportunities

Recent studies of the internationalisation of various currencies suggest that the process can occur much faster than originally thought. In particular, one widely quoted study found that the US dollar overtook sterling in official reserves just 15 years after the Federal Reserve Act promoted the US dollar's challenge to sterling in trade and finance and about 10 years after the US economy overtook the UK in size[11].

While China has clearly expressed its desire for the RMB to become a major global currency, the time horizon it has in mind has never been made clear publicly, and indeed may well be dependent on how the 'step by step' approach being followed pans out. Whether there will be setbacks and just how long the process will take is impossible to know: there is no historical precedent for a country to move in the direction of internationalising its currency in such a

11 See B. Eichengreen and M. Flandreau 'The Federal Reserve, the Bank of England and the Rise of the Dollar as an International Currency, 1914-39', BIS Working Papers, no. 3428, November 2010.

controlled and policy driven manner, as against the pace being primarily driven by market forces. However, both the USD and the JPY experience suggest that, if the Chinese authorities so wish and with the right conditions in place, the time horizon could be much shorter than many observers currently expect.

In the absence of some major setback or change in policy intent, the ongoing move towards internationalisation of the RMB is likely to be one of the main factors influencing the type, volume, currency denomination and location of financial flows and financial market activity around the world over coming decades. There are a number of reasons for this taking this view:

- China will, probably within 10 years, be the world's largest economy and the world's largest importer as well as exporter , with its geographically wide and diversified network of trade links making it the single most important economy with respect to global trade flows;

- Capital flows into mainland China remain relatively small and dominated by foreign direct investment, reflecting still tight controls on offshore portfolio flows into their debt and equity markets. However, the commitment of the Chinese Government to internationalisation of the RMB will if continued, and for reasons discussed above, require further ongoing relaxation of capital controls on inward and outward portfolio investment, along with a move to full currency convertibility.

The combination of the above factors will see a massive increase over time in trade- related and portfolio investment flows into and out of China, and in the associated provision of RMB denominated financial products and services for trade and other financing, risk management and investment purposes. As the RMB grows in importance as an international reserve currency, it may also over time become used in offshore-to-offshore financial transactions unrelated to trade or investment flows to or from mainland China.

As emphasized in the previous section, RMB invoicing needs to be seen in this broader context: that is, as just the first phase in this process of RMB internationalisation. How countries that do significant volumes of trade with China position themselves early in this process is likely to have an important impact on where they are positioned in ten or twenty years time, and on the extent to which their financial sectors are winners or losers as a result of these major market developments.

With respect to 'winners':

- Financial market activity always gravitates to where the liquidity is. In the current, first stage of RMB internationalisation, trade invoicing in RMB by exporters to China is, outside of Hong Kong residents converting US dollars or other currencies for RMB deposits, the only significant source of such offshore RMB liquidity;

- The Hong Kong example suggests that other offshore RMB centres and hubs may well be the main beneficiaries of the gradual relaxation of capital controls by China, as it liberalises controls on a 'step by step' basis;

- Consequently, financial centres and hubs that take advantage of this first phase to also develop RMB trade-related products and services will have an 'early mover' advantage as the internationalisation process increasingly encompasses capital account flows as well as trade flows;

- Countries that have in place the necessary financial ‘architecture’, including swap facilities and a local RMB clearing and settlement facility are likely to be best placed to take full advantage of the next phases of RMB internationalization.

On the ‘losers’ side, at least some of the new financial flows arising from RMB internationalisation will be substitutes for existing flows, rather than additional net flows. By way of example:

- As capital restrictions are eased and market access increased, Chinese financial assets will become major components of some benchmark indices, in particular global equity benchmarks, most likely leading to substantial shifts of capital into their markets and away from other markets.[12] On current market capitalisation, Chinese A shares would represent something like 14 per cent of the MSCI Emerging Market Index, or around USD 300 billion of the total market capitalisation of the index;

- Substantial use has been made of the AUD and of AUD denominated assets, in particular equities, as proxies for exposure to the Asian growth story and the China story in particular. As the RMB becomes fully convertible and capital controls are gradually eased, these ‘proxy’ trades will decline. If Australia does not position itself to take advantage of the opportunities arising from RMB internationalisation, it could end up a net ‘loser’ in the process.

In addition, the early locations of offshore RMB liquidity are likely to experience the strongest growth in RMB related financial flows and activity as the internationalisation process continues, in the process attracting talent and resources from other financial centres as RMB denominated financial transactions take up an increasing share of the total volume of transactions.

From a commercial point of view, there are of course short term costs associated with being an ‘early mover’, especially given uncertainty as to the pace and policy sequencing of ongoing RMB internationalisation. They need to be weighed against the potential long term gains, which this paper suggests could be substantial.

(c) RMB Internationalisation and Australia

Background: Is Australia Relevant to the RMB Internationalisation Process?

In fiscal year 2011-12, Australia’s total trade with China was valued at A$128 billion, or 20.4 per cent of our total trade in goods and services. China is now Australia’s largest export market (A$83 billion or 26.4 per cent of the total) and largest source of imports (A$45 billion or 14.5 per cent of the total).These ratios are, moreover, likely to rise further as China continues to grow faster than most of our major trading partners, although the composition is likely to change considerably over time on the export side as the massive growth in China’s middle class sees a growing demand for a wide range of higher end products and services. [13]

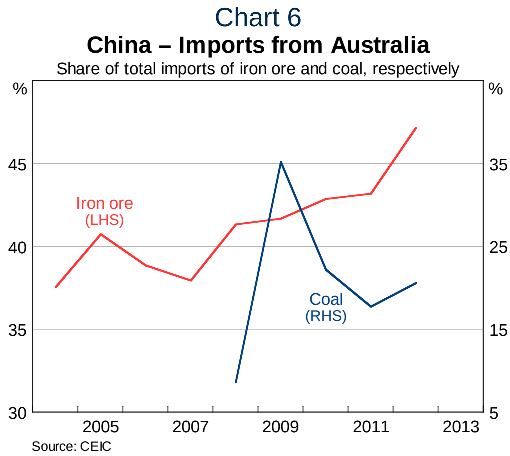
12 It has recently been suggested that, assuming China continues with the current pace of policy reforms, mainland Chinese shares could become part of global equity benchmarks “over the next three to five years”. See Financial Times, 7 March 2013, p. 15.

13 See on this point H Kharas and G.Gertz, ‘The New Global Middle Class: A Cross-Over from West to East’, Wolfensohn Center for Development, Brookings, 2010.

At present, Australian Bureau of Statistics data suggest that only a very small proportion of Australia's trade with China is invoiced in RMB. However, so long as some of the issues constraining greater invoicing are overcome (see next section), there are good reasons for thinking that this will increase over future years, potentially resulting in a build-up over time of RMB liquidity and financial products and services in Australia.

On the other side of the ledger, how important is Australia to China with respect to trade and financial flows? While China is now the major overseas market for Australia with respect to both our imports and our exports, Australia of course represents only a small percentage of total Chinese exports and imports (see chart 5), although we are a major source of Chinese imports in some key commodity areas such as iron ore and coal (chart 6)

Source Thomas Reuters

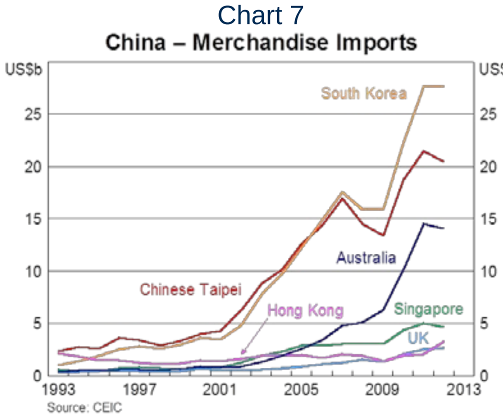


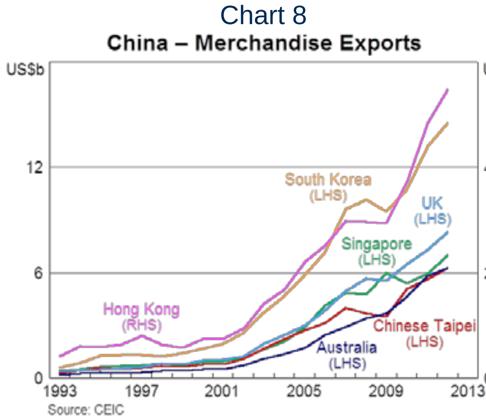
Source CEIC

Does that make us irrelevant in the ongoing process of RMB internationalisation? Data on trade with China by countries which are already offshore RMB centres or hubs or are moving in that direction put these Australian figures into perspective (charts 7 and 8 below). While the data are somewhat difficult to interpret with respect to Chinese exports due to the fact that Hong Kong is in many cases just an intermediary port for other ultimate destinations, they do suggest that, at least on the Chinese imports side, Australia is a larger supplier than for example the UK, Singapore or Hong Kong.

Of course, while Australia may be a larger trading partner with China than some of the above developing RMB hubs, some of them have other close historical links to mainland China that provide them with a natural demand for RMB assets.

China would appear to be focusing in the early stages on a mainly regional approach to RMB internationalisation. Whether this is a reflection of China's interest in regional financial co-operation and architecture, or simply a more pragmatic approach focused on those countries where there is a natural local demand for RMB for historical and other reasons, with Hong Kong at the centre, is unclear. Either way, assuming the internationalisation of the RMB continues, China's focus will inevitably extend beyond the immediate region, as indeed it is already doing in the ongoing discussions with the City of London on facilitating the further development of RMB business there.





To the extent that what develops over time is a regional 'hub and spoke' network, with Hong Kong at its centre and other locations developing strong financial links to Hong Kong and to each other, there are certainly good reasons why in principle Australia has the potential to become an important part of this regional RMB network. By way of example:

- Australia is in the same time zone as China but ahead of it. If over coming years the RMB becomes traded on a 24 hour basis, with links between offshore hubs and centres assisting in the provision of offshore liquidity but settlement still ultimately linked to the mainland China settlement system, Australia would be in the strategically important position of being the first major financial market to open after the US closes and before Tokyo and Shanghai, and would remain open for much of the Chinese trading day;

- There is a high degree of complementarity between the Australian and Chinese economies;

- Australia has a high and increasing degree of trade integration with Asia, with eight of our ten largest trading partners now in the region, which means that Australia could become an important part of the network of increasing interbank and other financial flows between offshore RMB centres and hubs in the region[14];

- Australia has a predictable, efficient and well-regarded legal framework and regulatory regime, with strong prudential oversight;

- Australia has one of the largest funds management sectors in the region, with efficient distribution platforms. Along with a robust banking sector, these are important factors in terms of providing both liquidity and confidence; and

- Australia has a world class payments settlement system.

Given the fact that, as mentioned earlier, the pace and geographic location of the early stages of RMB internationalisation are being controlled and driven by China, as against just by market forces, the extent to which *in practice* Australia develops as an offshore RMB hub is of course very much in the hands of the Chinese authorities. However, there are reasons for optimism on this front as well. Firstly, it is notable that in 2012 China and Australia entered into a bilateral currency swap agreement. The swap facility is the fourth largest after Hong Kong, Singapore and South Korea. Similarly, it is also encouraging that China is in

14 Discussions with senior investment bank executives in Asia suggest that, as was the case with the development of the Eurodollar market, a network of offshore RMB hubs and centres is likely to develop over time servicing multinational clients and allowing 24 hour offshore trading and settlement, with interlinkages assisting in the provision of adequate liquidity.

discussions with Australia over establishing direct trading of AUD/CNY within mainland China which, if successful, means the AUD will become just the third major currency outside of USD and JPY to have direct trading against CNY.

There are also strategic considerations that may be relevant. As noted earlier, Australia is an important supplier to China of minerals and energy and to a lesser extent of agricultural products, items of substantial importance to China. Australia is also, outside of Hong Kong, the major recipient of Chinese direct foreign investment[15] concentrated in these areas of strategic importance, although the flow of such direct investment has slowed in recent years. From Australia's perspective, while the stock of Chinese direct investment remains low, it has risen rapidly. [16]

Looking beyond direct investment flows, as China continues to liberalise outflows of capital from the mainland consistent with its 'go global' strategy referred to earlier, Australia may well become an important location for Chinese portfolio investment as well, complementing the direct foreign investment referred to earlier. A recent study on Chinese direct investment in Australia suggested that, given some of the sensitivities in Australia — perceived or real — over direct investment in strategically important sectors of the economy, China may over time look increasingly for other ways to achieve their objectives, in particular by way of more portfolio investment. [17]

In the revised regulations published by the China Insurance Regulatory Commission in Oct 2012 for Chinese domiciled insurance companies' offshore investment, up to 15 per cent of their assets are permitted to be invested overseas, and Australia is included among the 25 developed markets permitted. In addition, insurance companies are now permitted into real estate investment products offshore, an asset class in which the Australian funds management sector is a world leader. Similarly, recent revised QDII guidelines permit mainland China investment in Australia among other markets.

In short, there are encouraging reasons for thinking that, as more Australian trade with China is invoiced in RMB and Australia remains an important destination for Chinese direct and portfolio investment flows, China may be willing to encourage and support Australia's development as a location for the expansion of the network of offshore RMB hubs.

Short Term Issues and Opportunities: RMB Invoicing Survey

While RMB invoicing is just the first stage in the ongoing process of RMB internationalisation, it is a very important one for countries looking to develop as offshore RMB hubs, since outside of Hong Kong it is at present the only significant source of RMB liquidity.

Despite recognition by many Australian exporters to and importers from China of the potential benefits arising from RMB invoicing — including improved pricing and possible access to new clients in mainland China — Australian invoicing in RMB, while showing solid growth in recent years, is still very limited. This is not surprising on the export side: as discussed earlier, Australian exports to China are dominated by mineral resources that are

15 While still small in stock terms, China's share of total offshore direct investment has been rising rapidly and has the capacity to continue to grow very rapidly, given the size of China's economy, its very large stock of foreign assets and the fact that these assets are not well diversified. This would also be consistent with China's 'go global' policy focused on encouraging overseas direct investment for strategic and diversification reasons, amongst others.

16 For a recent survey of Chinese direct investment in Australia, see John Larum and Jingmin Qian, 'A Long March: The Australia-China Investment Relationship', Australia China Business Council, October 2012.

17 See John Larum and Jingmin Qian, op. cit.

priced in US$, so from both an Australian exporter's and a Chinese importer's perspective invoicing in US$ makes sense.

Will this change over time? In terms of sheer trading volumes, China is already the most important single player in a wide range of commodity markets. As part of its desire to internationalise the currency and diversify its foreign exchange reserves away from US$, China is also keen to become a central hub for pricing and trading of commodities in Asia, thereby increasing the amount of commodity contracts priced and denominated in RMB. The Shanghai Futures Exchange recently announced it would launch an RMB crude oil contract. The exchange already quotes copper, aluminium, zinc, gold, silver and rubber in RMB.

However, discussions with senior executives at a number of large commodity exporting companies suggest that, at least at this stage, they are not seeing any pressure at all from Chinese importers to invoice in RMB. From a risk management perspective, and given that typically commodity exporting companies- as against some other exporting companies- have limited presence in China and limited exposure to RMB liabilities, they would prefer to avoid RMB exposure. A change to RMB invoicing would have much wider ramifications for their treasury and risk management operations given that many of them are, in effect, run as $US companies; consequently, they have no incentive to switch to RMB invoicing unless there are clear and strong pay-offs from doing so. While they agree that RMB pricing of commodities may eventually occur, they typically see this as being a long way off.

Whether this assessment is correct remains to be seen. However, what is clear is that a world in which most commodities are priced in RMB could see substantial changes in the treasury and risk management arrangements of commodity exporting companies, with associated needs for a range of RMB related products and services.

Looking beyond commodities, over time and for reasons mentioned earlier Australian exports to China are likely to become increasingly diversified, focused on higher value added goods and a range of services. In the shorter term however, the *Bank Customer Survey* conducted for the RMB Dialogue suggests that there are a number of other factors that are significantly inhibiting Australian non-commodity exporters to and importers from China from invoicing in RMB, in particular:

- ability to hedge exchange rate exposure;
- the onerous administrative burden associated with gaining Chinese approval to settle trade in RMB;
- time delays in the settlement process; and
- a lack of interest in RMB invoicing by many Chinese companies.

Despite these perceived constraints and the still very low level of RMB invoicing by Australian companies, the broader survey results were quite positive in many respects with respect to future prospects:

- use of RMB invoicing has been increasing rapidly, albeit from a low base;
- one of the major factors listed that is discouraging companies from invoicing in RMB, namely lack of adequate FX hedging instruments, is capable of being addressed through a combination of greater awareness by companies of what is already available and increased provision of such products by Australian domiciled banks;

- many companies were looking to increase their use of RMB invoicing in the future; and
- many companies expected more Chinese companies to push for RMB settlement in the future, and wanted to be in a position to respond to this.[18]

In short, there are enough elements in the survey to suggest a natural market constituency in favour of further RMB invoicing going forward. Nonetheless, more work needs to be done on understanding constraints to RMB invoicing and looking at ways of reducing them. The Centre for International Finance and Regulation and the Shanghai University of Finance and Economics are working on a possible joint research project. Initially the research will focus on:

- surveying Chinese and Australian businesses about their use of and attitude towards RMB invoicing, including potential benefits and perceived obstacles ; and
- Identifying and analysing potential policy and regulatory impediments to the sustainable and efficient development of an RMB market from an Australian perspective.

Medium Term Issues and Opportunities

A number of Australian domiciled banks are already providing a wide range of RMB related products and services, including:

- RMB cash account services, deposits and online banking;
- trade finance loans;
- commercial loans;
- deliverable and non-deliverable forward foreign exchange contracts;
- foreign exchange options; and
- some investment products.

However, while the data on the size and structure of the RMB market in Australia are very limited, it would certainly appear that the liquidity and depth of many of these products and services in Australia is quite limited. There is a certain degree of circularity in this: the limited liquidity and availability of RMB related products and services may be a factor constraining RMB invoicing by Australian companies, which in turn is inhibiting the build-up of RMB liquidity. As noted earlier, however, there are good grounds for believing that RMB invoicing is likely to increase over time.

While as noted earlier financial market activity always gravitates to where the liquidity is, the global financial crisis also demonstrated just how rapidly liquidity can disappear once confidence evaporates. Liquidity and confidence go hand in hand: both users and providers of financial products and services need both liquidity today and confidence that it will still be here tomorrow. This has both market and policy dimensions, both of which are discussed below.

18 A recent survey of around 700 Chinese trading companies by HSBC found that three quarters of them expected the proportion of Chinese trade that is invoiced in RMB to more than double by 2015. See Wall Street Journal, “Bradken Eyes RMB Bond”, November 5 2012.

Liquidity and the market

As RMB invoicing by Australian companies continues to increase — which the survey results referred to earlier suggest is likely — so will the demand for RMB hedging and other products. As capital controls are eased further over time — for example, via expansion of QFII and RQFII quotas — so the range and liquidity of products widens, not just for exporting companies that may be wanting to hold RMB for a period if they have future RMB liabilities or to hedge out their RMB exposure, but also potentially for investors and fund managers, especially once China becomes part of some of the global indices. In turn, as the breadth and liquidity of offshore RMB investment, hedging and other products increases, RMB trade settlement becomes more appealing, further adding to liquidity. In short, there is scope over time for a 'virtuous cycle' as invoicing increases and capital control are further eased.

There will also be increasing scope over time for Australian domiciled companies to take commercial advantage of the gradual easing of Chinese capital controls. An interesting example is a company in Australia that holds an exchange licence and is looking to encourage Chinese firms — particularly small and medium size firms that are finding it extremely difficult to list on mainland China exchanges — to list in Australia, in both AUD (for Australian investors) and RMB (for Hong Kong and hopefully over time mainland Chinese investors) and to build up a range of other financial services around this.

There are also a range of Australian funds management companies that are positioning themselves to take advantage of the recent and prospective further relaxation of Chinese domestic regulations and capital controls, such as insurance companies now being allowed to contract out management of their investments and to invest partly in non RMB assets; and the significant reforms in recent years to the Chinese capital markets which have in principle allowed securities companies and trust companies to provide a much wider range of products to retail, high net worth and institutional clients. Because many of these Chinese companies do not yet have well developed risk management systems in place, this can provide opportunities for joint ventures by Australian companies.

These and other recent changes to the regulatory environment have resulted in a range of Australian funds management companies:

- building strategic alliances with Chinese institutions that are able to invest abroad, in some cases with a focus on real estate and infrastructure- two asset classes in which the Australian funds management sector is a world leader;

- looking to establish joint ventures with Chinese companies that will allow them to provide more sophisticated RMB capital market products to retail, wholesale and high net worth clients in China, along with their risk management processes and skills; or

- seeking a QFII licence or an increase on an existing QFII quota, in order to develop or expand investment opportunities in Chinese assets for Australian or offshore investors.

In time, further liberalization of capital controls and the build-up of links between offshore RMB centres and hubs will mean that, increasingly, RMB liquidity will be available from sources other than just trade invoicing. But the timing of this process, and just how smooth or otherwise it will prove to be, is quite uncertain. That is why, in the interim, confidence that the financial architecture is in place to facilitate access to liquidity- including in periods of market stress- will also be crucial for financial centres wanting to take full advantage of this ongoing process of RMB liberalization. That is where the policy dimension becomes important.

Liquidity and financial architecture

- Swap facility.

As noted earlier, Australia has the fourth largest swap facility with China- CNY 200 billion. The fact that China encouraged the establishment of this agreement is in itself very positive.

From a market confidence perspective, it will also be important over time to see the swap facility fully operationalised and ready for use should circumstances arise where it was required. It would also be very helpful if the RBA can provide some public guidance as to the circumstances in which in principle it would be prepared to utilise the facility, and the terms surrounding its provision. Discussions with the RBA indicate that this will be done at an appropriate time.

- Direct trading

Australian officials are currently in discussions with the Chinese authorities on measures designed to facilitate direct trading of AUD/CNY in mainland China. At present, the People's Bank of China each morning announces an official rate for CNY/USD, and then soon after also announces a rate for CNY/JPY with reference to quotes that it receives on this from a group of 20 or so designated market makers. What is under discussion is a similar arrangement for the $A.

It is very encouraging that these discussions are underway, and that hopefully the $A will soon become just the third major currency in terms of trading volumes to have direct trading against the RMB. They are an important signal of the desire at an official level for closer financial relations between Australia and China. The impact of direct trading on market pricing and liquidity is harder to gauge. On the one hand, market makers providing an indicative rate to the PBOC and then to the market each day will — as do traders currently making a price to customers in AUD/CNY — still use the USD/CNY rate announced that morning by the PBOC as the key element in the 'price discovery' process for determining their indicative AUD/CNY rates. However, direct trading in AUD/CNY is likely to lead to more banks — including Australian banks — becoming market makers in AUD/CNY and being able to participate actively in the interbank market, which should improve liquidity and pricing. As for the example of direct trading in CNY/JPY since June 2012, there seem to be a range of views as to what if any lasting impact there has been on liquidity and spreads.

- RMB clearing and settlement bank

As noted earlier Bank of China (Taipei) has very recently commenced operations as a CNY clearing and settlement bank, joining Bank of China (Macau). ICBC (Singapore) is also likely to commence in the near future. However, the vast bulk of offshore clearing and settlement still occurs through Bank of China (Hong Kong).

While it is very clear from the Bank Customer Survey referred to earlier that the administrative processes associated with settling trade in RMB are seen as quite onerous, the burden seems to be mainly associated with providing documentation to the Chinese authorities to prove that the purchase or sale of CNY is directly trade- related. The fact that the clearing and settlement occurs indirectly, largely via Bank of China (Hong Kong) as against via an Australian domiciled bank, does not of itself appear to add to this administrative burden faced by the company.

Once most capital account controls have been substantially liberalised or removed, non-residents will be able to obtain CNY from sources other than trade related transactions. As international use of the RMB increases substantially, the network of RMB clearing and settlement banks will need to be expanded to include Chinese and other banks around the globe, if only to avoid concentration risk. In the interim, the question arises as to the importance of countries looking to establish themselves as offshore RMB centres and hubs having a locally domiciled clearing and settlement bank.

While Singapore and Chinese Taipei have clearly seen this as desirable, it would appear, at least from press reports, that the negotiations underway between the UK and China with respect to facilitating the growth of RMB business in London have not included the issue of having a locally domiciled settlement bank. It may be that this largely reflects the fact that, as the biggest foreign exchange trading centre in the world, London does not feel it needs this, either from the point of view of market efficiency or liquidity and market confidence.

Decisions as to whether and where to set up further offshore RMB clearance and settlement banks going forward is, of course, entirely one for the Chinese authorities to make. From an Australian perspective, it would not seem that the depth of RMB business is there currently to make a compelling case for having a local settlement bank.

However, if as seems likely the volume of trade invoicing by Australian companies continues to grow strongly, along with the range and depth of RMB related trade and investment products and services, then a point may soon be reached where, along with an operationalised swap agreement and direct trading of AUD/CNY, having a locally domiciled clearing and settlement bank would be beneficial in terms of market confidence and liquidity. This may be an issue which, at an appropriate time, Australia might wish to raise with China. As mentioned earlier, their encouragement of the establishment of a swap facility and their agreement to discussions over AUD/CNY direct trading suggest that , if in the near future a case can be made for having such a locally domiciled settlement facility, China may be prepared to consider it.

- Regulatory hurdles and market access

Mention was made earlier of the attraction of Australia to China as a destination for both direct and, going forward, portfolio investment. On the other side of the coin, Australia's superannuation system has meant that we have a massive pool of funds under management- of the order of $A 1.5 trillion and, on Treasury estimates, likely to be over $6 trillion in 25 years time.[19]

Increasingly, reflecting both the need for diversification and the attractive investment opportunities in the region, Australian funds will be looking to invest in China and other countries in the region. They will become a source of local demand for both RMB and for various RMB products and services, such as hedging instruments. As mentioned earlier, a range of Australian funds management companies are already well down this track in terms of putting in place the platforms, capabilities and know-how to do so.

These two-way portfolio investment flows are likely over time to become an important part of the broadening and deepening financial links between China, Hong Kong and Australia. However, one of the many constraints that currently exist in this area and inhibit such flows is the very different regulatory environment applying to the funds management industry in different countries in the region.

19 See Martin Parkinson, 'Future Challenges: Australia's Superannuation System', address to ASFA Annual Conference, November 2012.

Following on from a recommendation in a 2009 report to the Federal Government by the Australian Financial Centre Forum[20], Australia has been actively involved in negotiations in the region on the establishment of an 'Asian Funds Management Passport'. The idea is to develop a combination of a common regulatory framework which as far as possible would enable a fund that is registered in one passport member country to be sold in any other passport country, without having to be registered again. These regional negotiations are being conducted under the auspices of APEC, and with the explicit endorsement of APEC Finance Ministers.

Recently, China joined the regional negotiations on the Passport. While, negotiation of such an agreement is extremely challenging and, if successful, will take a long time to put fully in place, it has the potential — in combination with the likely continual easing of Chinese capital controls on both inward and outward portfolio investment- to make it substantially easier for funds domiciled in Hong Kong or mainland China to be sold in Australia, and vice-versa.

(d) Conclusion: Building on Opportunities

The size of the Chinese economy and of its trading links with the rest of the world mean that, if it continues down the path of RMB internationalisation, the implications over time for global financial markets will be enormous.

Countries that have built up RMB liquidity and RMB related financial products and services early in this process, and have the right financial architecture in place, will be well positioned to benefit from these changes in financial markets. Through increased trade invoicing in RMB and — at an appropriate time, and with the agreement and encouragement of the Chinese authorities — some further policy changes, Australia has the opportunity to both participate in and benefit from the seismic changes in global financial markets that have just begun.

Just as closer trading relationships lead to demand for a wider range of and more liquid financial services, so improved RMB financial services and products in Australia can facilitate even closer trading relations, with ongoing benefits to both the Australian and Chinese economies.

20 See Australia Financial Centre Forum, 'Australia as a Financial Centre: Building on our Strengths', November 2009, pp. 84-88.