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Close control of its currency, the renminbi, has been a hallmark of Chinese economic policy in the modern era. Yet as the economy matures, the need to develop internal capital markets, ease monetary policy pressures and—ultimately—open the capital account has become more pressing. Since China introduced renminbi trade settlement in 2009, the country’s efforts at currency liberalisation have been characterised by rapid development abroad and a series of obstacles at home. By the end of 2013, the renminbi had risen to become the second most-used trade financing currency and ninth most-used currency for payments globally.

As invoicing in renminbi has grown, China has allowed more trading in renminbi products to take place in competitive offshore markets outside the direct control of domestic regulators. The growth of this market has enabled China to experiment with reforms and, many think, has pushed the government to remain committed to liberalisation. But the risks are considerable, and the pace and timing of reform remain largely a matter of speculation. Institutional investors (IIs)—which are raising their exposure to renminbi-denominated securities even as they clamour for more information about reforms—have varied views on what those risks are and how long the process will take. Perhaps unsurprisingly, nowhere are opinions more sharply divided than between those headquartered in mainland China and those based elsewhere.

To be sure, those based in China have a much greater stake in the development of the currency, which is tied inextricably to their own future, than those outside the country, who are merely using it as an investment vehicle. But as China’s economic influence grows, the global importance of the renminbi will become magnified. Indeed, while for decades it has been a “greenback world”, dominated by the US dollar as the world’s primary reserve currency, many think a “redback world”, in which the renminbi enjoys premier status, is increasingly a possibility. But getting there will not be easy or straightforward. There are significant, and revealing, differences in the opinions of IIs inside the country and those based outside it on the pace, process and likelihood of reform.

This report seeks to examine these differences. According to the survey conducted for this paper, the most striking revolve around onshore and offshore investors’ understanding of the competing priorities facing Chinese authorities: gaining access to international markets and maintaining institutional stability. China-based investors, who have more exposure to Chinese clients and Chinese policymakers,
see both more risks that liberalisation will be delayed by political considerations, and more rewards for China’s economy once liberalisation is completed. Offshore investors, with more exposure to global markets and more access to global capital flows, see the demand for international capital in China outweighing the risks involved in reforms—but they are less optimistic about the benefits opening up will bring the economy.

Moreover, while there is general agreement among investors that China will fully open up its capital account within 10 years, these differences between onshore and offshore institutions have a significant effect on how respondents expect liberalisation to proceed. China-headquartered IIs expect more incremental reforms meant to protect domestic depositors and expand onshore trading, while foreign investors expect a more substantial overhaul of China’s banking system in order to improve competitiveness in international markets.

The key findings from the survey include:

- **A majority of respondents think the renminbi will one day surpass the US dollar as the world’s major reserve currency.** Fifty-three per cent of respondents say that the renminbi will one day surpass the dollar as the top currency in international holdings of foreign-exchange reserves. Within China there is more optimism: 62% of IIs see a redback world on the horizon, compared to 43% of those outside China. But the view is far from uniform: one in five (21%) of China-headquartered IIs say that they do not expect China ever to fully open its capital account, compared with only 2% of foreign respondents who hold the same view.

- **Respondents are confident that liberalisation will be completed over the medium term but are less certain about potential short-term reforms.** Two-thirds of respondents expect China to complete its financial liberalisation within ten years, with a majority expecting major reforms within five. Respondents are more hesitant about the prospect of possible short-term reforms, though, with only 49% expecting the introduction of a deposit insurance system within three years and only 46% expecting China to lift interest-rate caps over the same timeframe.

- **China-headquartered IIs are more concerned about political barriers to liberalisation.** Among many reasons why China’s authorities may be inclined to be cautious about opening up their financial system, China-headquartered IIs are more likely to identify political factors as potential barriers. Their largest concern is government finances, with 70% of China-based respondents citing this as a major obstacle. They also see reforms in this area as both more urgent and less likely to happen over the medium-term than foreign respondents, with 64% ranking the reform as urgent or very urgent and 40% saying it is likely to be completed in three years, compared to 58% of foreigners ranking the reform as urgent and 43% saying it would be completed in three years.

- **Foreign investors expect China to privatise its banking system sooner rather than later.** Nearly half (47%) of foreign-headquartered IIs expect China to privatise its banking system within three years, compared to just 19% of domestic respondents. Though 93% of China-based IIs say they expect banks eventually to be privatised, privatisation is seen as the least-urgent reform facing China, with one-third (34%) of China-based respondents saying they expect the reform to take more than five years. Foreign respondents also expect faster reforms opening up the financial sector to foreign markets and competition from foreign banks.

- **Despite seeing more political barriers to reform, Chinese IIs are more optimistic about the benefits to the economy and the renminbi’s future role in international currency markets.**
A majority of Chinese-headquartered IIs expect financial liberalisation to speed up economic growth and improve export competitiveness. Some 30% of China-headquartered respondents think the renminbi is likely to become one of the top-two traded currencies in the world by 2020, an opinion not shared by any foreign-headquartered IIs. Forty-one per cent of foreign-headquartered investors say that they expect financial liberalisation to lead to a slowdown in China’s economy, compared to 27% of Chinese institutions. Although a larger percentage of foreign respondents say that they expect liberalisation to be positive for the Chinese economy (48%), this still reflects a substantial amount of scepticism about the ability of the Chinese financial sector to compete on an open market.

- **Foreign investors are more likely than domestic investors to see the renminbi as currently at a fair value.** Despite the diplomatic sensitivity around the value of the renminbi and its impact on export markets, foreign IIs are more likely than domestic ones to say that the currency is currently at a fair value, with 37% expecting that the value will not change due to liberalisation, compared to 18% of China-headquartered IIs. Among respondents who expect liberalisation to have an impact on currency valuations, the survey finds uncertainty as to whether it would lead to appreciation or depreciation, with 40% of respondents saying they expect the former and 35% the latter.

- **Interest in offshore renminbi from Chinese investors is growing faster than interest from foreign investors.** While interest remains robust among both onshore and offshore clients for renminbi-denominated (CNH) products outside the mainland, Chinese investors are more likely to want to expand their holdings of CNH products over the next 12 months due to faster expected appreciation, demands for portfolio diversification and the need to ease cross-border trade.

- **Chinese IIs are substantially more optimistic about the prospects for Chinese equities over the short term.** Reinforcing the overall optimism from China-based investors on the strength of the domestic economy, respondents in China see a bullish market for mainland equities in 2014, with 40% looking to increase their exposure onshore and 38% looking to increase their exposure to offshore equities, compared with 25% and 19% respectively for foreign-based companies.

- **Chinese IIs expect offshore renminbi trading to expand at home.** While respondents agree that Hong Kong will continue to dominate trading over the next three years, Chinese IIs rank Shanghai and other onshore free trade zones (FTZ) as the second place where trading is likely to see rapid growth, while non-Chinese IIs think Singapore is a more likely growth area. Those in China rank the expansion of the Shanghai FTZ and possible future FTZs as the most urgent currency-related reform facing China’s government.
About the research

*Renminbi rising: Onshore and offshore perspectives on Chinese financial liberalisation* is an Economist Intelligence Unit (EIU) report, commissioned by State Street. The EIU conducted a survey in December 2013 of 200 senior executives at institutional investors with knowledge of their exposure to renminbi assets. Respondents were split equally between firms headquartered in mainland China (excluding Hong Kong and Taiwan) and those based elsewhere, and between asset managers (including institutional, retail and hedge funds) and asset owners (including insurance companies, sovereign wealth funds and pension plan sponsors). Forty-eight per cent of respondents represent firms with global assets under management in excess of US$10bn. In addition, the EIU conducted in-depth interviews with a range of senior executives and analysts. The report was written by Bradley Gardner and edited by David Line.

Totals may not add up to 100% either due to rounding or because respondents could select more than one answer.

We would like to thank all those who participated in the survey and the interviews for their time and insight. The EIU bears sole responsibility for the content of this report.
Over the past two decades China’s financial sector has survived two major financial crises in part due to the protection afforded it by a closed capital account. While the Asian and global financial crises destabilised other emerging economies and restricted funds available for recovery, China’s managed monetary policy gave it close control of its financial system, preventing outflows and giving regulators the latitude to tackle weaknesses in better economic times.

Stability has come at a price. With limited access to international capital markets and market-based risk-management systems, China’s financial sector has not developed as rapidly as the rest of its economy. The consequences have so far not been dire but there are increased signs of tension in the system. As labour costs have risen, Chinese companies are demanding more access to capital in order to invest. Meanwhile banks are struggling to absorb a growing pool of local government debt arranged through poorly monitored finance vehicles—as well as poorly monitored securities issued through a “shadow banking” network that has sought to circumvent the limitations of the regulated financial sector.

**Liberalisation timescale**

Until relatively recently, financial flows in China have been overwhelmingly concentrated in the country’s largest state-owned banks. As the economy grew, secondary financial markets were developed, such as the Shanghai and Shenzhen stockmarkets and those for corporate and central government bonds, but these were tightly controlled in order to keep capital in the banking system in the form of deposits. Similarly, the government restricted cross-border flows which would otherwise allow savers to move money abroad. The restrictions simplified the conduct of monetary policy and allowed banks to keep deposit interest rates low in order to subsidise loans to loss-making state-owned enterprises (SOEs), at the cost of large-scale capital misallocation and reduced access to international capital markets.

Modest steps towards partial capital account liberalisation began in 2002, when the Chinese government introduced the qualified foreign institutional investor (QFII) scheme which allowed some offshore investors to purchase Shanghai- or Shenzhen-listed stocks. In 2003, Hong Kong received permission to introduce renminbi-denominated retail banking. In 2005, China removed the renminbi’s peg to the US dollar, replacing it with a managed float tied to a basket of currencies. Then in 2007, the government introduced rules for companies raising renminbi through offshore bonds (“dim sum” bonds). On the other side of the divide, China launched the qualified domestic institutional investor (QDII) programme in 2006, allowing some domestic investors to send money overseas.

Liberalisation only really took off after 2009, when the government allowed cross-border trade settlement in renminbi, which opened the current account. This led to a growing pool of offshore funds with few means of repatriation.
and reinvestment. The government substantially eased the process of listing offshore bonds in 2010 and, in 2011, it introduced the renminbi qualified institutional investors (RQFII) programme which allows investors to repatriate renminbi by investing in onshore securities. All of these reforms are still limited in scope though, with strict quotas for how much currency can moved across the border. In addition, they fail to address the underlying reason behind China’s closed capital account—the immaturity of its financial sector and the need to support SOEs. Whether or not full currency liberalisation will occur and, if it does, how long it will take, remain open to question.

There is broad consensus among all respondents to the survey conducted for this report that the Chinese government is committed to completing the reform process, with only 11.5% of respondents saying that they do not expect China ever to liberalise its capital account. Notably, China-headquartered institutional investors are more sceptical, with 21% saying that they expect China never to fully liberalise. An additional 8% of Chinese institutional investors think full liberalisation will take 20 years (Figure 1).

Likely reforms and potential barriers
Most respondents expect China to fully liberalise its currency within 10 years, with many major reforms necessary for that goal to be carried out expected within five. But clarity is an issue: while there is confidence about the general direction of financial sector liberalisation (two-thirds of all respondents say the Chinese government has communicated its priorities in this area well), there is considerable uncertainty over short-term reforms.

For instance, the majority of China-headquartered IIs expect the government to lift interest rate caps and introduce a deposit insurance system within the next three years. But foreign-headquartered respondents are more doubtful, with only 38% expecting China to lift interest rate caps, compared with 54% of Chinese respondents, and 47% expecting the introduction of a deposit insurance system, compared with 51% of Chinese respondents (Figure 2).

The biggest difference between onshore and offshore respondents is seen in their views of likely banking-sector reform. Some 47% of foreign-headquartered IIs say that they expect

Figure 1
How many years until China completes financial liberalisation (% respondents)

<table>
<thead>
<tr>
<th>Years</th>
<th>China IIs</th>
<th>Non-China IIs</th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td>29</td>
<td>27</td>
</tr>
<tr>
<td>10</td>
<td>29</td>
<td>44</td>
</tr>
<tr>
<td>15</td>
<td>10</td>
<td>24</td>
</tr>
<tr>
<td>20</td>
<td>8</td>
<td>2</td>
</tr>
<tr>
<td>Never</td>
<td>21</td>
<td>2</td>
</tr>
</tbody>
</table>
China to privatise its banking sector within three years, compared to just 19% of Chinese IIs who think the same. The latter see banking sector privatisation as not only unlikely but also unnecessary, ranking it the lowest reform priority for the government, with more interest in reforms that would strengthen existing banks and allow them to compete internationally.

“We believe the banking sector reform itself has already been completed,” says a representative for Bank of China interviewed for this report. “In the coming decade, the challenge facing the Chinese banking sector is how it is going to compete in fully liberalised interest and exchange rate environments.”

China-headquartered investors do not believe that banking-sector privatisation is either necessary or likely in part because they are more keenly aware of the importance of state control of the financial sector in fulfilling economic policy. Indeed, some 64% of Chinese respondents see the government’s need to support economic growth as a major political barrier to eventual liberalisation, compared to just 39% of foreign respondents. Similarly, poor borrowing practices within local governments

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**Figure 2**

Reforms expected within three years

<table>
<thead>
<tr>
<th>Reforms</th>
<th>China IIs</th>
<th>Non-China IIs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate liberalisation</td>
<td>9%</td>
<td>54%</td>
</tr>
<tr>
<td>Deposit insurance system</td>
<td>47%</td>
<td>51%</td>
</tr>
<tr>
<td>Crisis management framework</td>
<td>45%</td>
<td>42%</td>
</tr>
<tr>
<td>More zones for onshore trading</td>
<td>40%</td>
<td>42%</td>
</tr>
<tr>
<td>Government finance reform</td>
<td>43%</td>
<td>40%</td>
</tr>
<tr>
<td>Consolidation of SOEs</td>
<td>42%</td>
<td>38%</td>
</tr>
<tr>
<td>Unrestricted FDI in banking sector</td>
<td>38%</td>
<td>37%</td>
</tr>
<tr>
<td>Mutual recognition of funds</td>
<td>44%</td>
<td>38%</td>
</tr>
<tr>
<td>Allow banks to freely lend overseas</td>
<td>44%</td>
<td>36%</td>
</tr>
<tr>
<td>Free-floating exchange rate</td>
<td>43%</td>
<td>31%</td>
</tr>
<tr>
<td>Banking sector privatisation</td>
<td>47%</td>
<td>19%</td>
</tr>
</tbody>
</table>
and SOEs is seen as a political barrier to liberalisation by 70% of China-headquartered respondents compared to 58% of foreign respondents (Figure 3).

Many foreign respondents, on the other hand, think that capital account liberalisation is inevitable and express confidence that major reforms to China’s banking and fiscal system will go hand in hand. “The momentum for internationalisation of the RMB is now irreversible as China’s economy has grown to be the second largest in the world and more than 10% of the country’s trade is now settled in renminbi,” says Raymond Gui, managing director and senior portfolio manager at Income Partners, who runs two renminbi offshore bond funds in Hong Kong.

Offshore respondents are moderately more optimistic about the prospects for government finance reforms and SOE reform, with 80% of non-China respondents, in both cases, saying that they expect reforms within five years, compared to 73% of Chinese institutional investors.

Part of this is the interconnectedness of financial-sector reform. “Once you start liberalising its very difficult to control it and to draw a line anywhere,” says Mark Boleat, chairman of the Policy and Resources Committee of the City of London, which has made a concerted effort in recent months to position itself as a key offshore renminbi market. “The largest barrier is the natural Chinese approach that they wish to control liberalisation, which means that they would like to moderate the pace of change and try to control the direction, but I think the general view is that the markets are in the process of being liberalised and it is not capable of being stopped.”

What needs to be done next?
This contrast between China-headquartered investors, who see more political risk to liberalisation, and those outside China, who see reform as inevitable, is reflected in divergent opinions on the most urgent reforms needed in order for China to safely open its capital account.

Chinese IIs list the growth of onshore trading centres, such as the Shanghai FTZ, and the creation of a deposit insurance system as the two most urgent reforms to prepare the ground for liberalisation, reflecting both the government’s desire to maintain control over renminbi currency markets and the political risk involved if one or more Chinese bank were
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Foreign respondents, by contrast, cite the relaxation of restrictions on overseas lending by Chinese banks and the privatisation of the banking sector as the country’s two most important reforms, reflecting concerns about the ability of Chinese banks to compete abroad once reforms inevitably proceed. Contrary to China-based investors, foreign-headquartered respondents see the introduction of a deposit insurance system as the least-urgent reform facing Chinese regulators, reflecting concerns about the systemic risk associated with deposit guarantees (Figure 4).

More moderate divergences are seen on a host of other issues reflecting this divide. China-headquartered respondents are more interested in reforms that will control systemic risks in the banking sector, through consolidation of SOEs, government finance reform and the introduction of a crisis management framework. Foreign respondents are more interested in reforms that will increase financial sector competition either through expanding foreign investment in the banking sector, lifting interest rate caps or allowing a floating exchange rate.

These divergences point to another major difference. While China-headquartered respondents see domestic reforms as a necessary precursor to opening up the capital account, foreign-headquartered respondents expect liberalisation and banking reform to occur side-by-side.
“Liberalisation is part of the answer to addressing issues [in the banking sector],” says Geoffrey Lunt, senior product specialist for fixed income at HSBC Global Asset Management. “In order to dis-intermediate the bloated banking system China needs to build a proper capital market, and in order to do that it needs both Chinese investors to be able to invest outside China and foreign investors to be able to invest inside China.”
Despite expressing more scepticism on the prospects for reform, Chinese IIs are more optimistic about the potential benefits of financial liberalisation and the underlying strength of the Chinese economy underpinning those gains. The size of this divergence is substantial, with almost one-third (30%) of China-headquartered respondents expecting the renminbi to be one of the top-two traded currencies in the world by 2020, while no foreign investor expresses the same optimism (Figure 5). The largest percentage of foreign respondents expect China to have the sixth most-traded currency, with one-quarter expecting the currency to either stay at or fall below ninth position.

“Renminbi liberalisation will attract more international investors and companies to use renminbi as a payment currency, trading currency and reserve currency,” says the Bank of China representative. “This will help to build a more stable international monetary system, along with the US dollar, euro and sterling, and thus benefit the world economy.”

Unsurprisingly, with this brighter view of the Chinese economy, China-headquartered respondents also expect better outcomes if financial liberalisation is completed effectively. Some 59% say that they expect financial liberalisation to lead to economic growth, compared with 48% of foreign-headquartered investors. In addition, a majority (54%) of China-headquartered respondents say they expect liberalisation to improve China’s already

**Figure 5**

<table>
<thead>
<tr>
<th>Rank of the renminbi in global currency markets by 2020 (% respondents)</th>
</tr>
</thead>
<tbody>
<tr>
<td>First</td>
</tr>
<tr>
<td>12</td>
</tr>
</tbody>
</table>
substantial position in export markets, compared with only 38% of those outside the country (Figure 6).

Despite the diplomatic and political tensions surrounding currency appreciation in China, bullish views on Chinese exports do not correlate with respondents’ views on the likelihood of currency appreciation. Among domestic respondents, 45% believe that the currency will appreciate following liberalisation, compared with 37% who believe the currency will depreciate and 18% who say it will stay the same. This reflects a consensus within China that any advantages exporters enjoy from an undervalued currency are outweighed by other factors, such as increased costs of funding and risks related to dollar invoicing.

The controversy surrounding renminbi appreciation is not reflected in offshore views either. Foreign-headquartered investors are more likely than those in China to say that the renminbi is currently at a fair value, with 37% expecting that currency liberalisation will have no net effect on the exchange rate, compared to 18% of those in China who hold a similar view. Among all respondents, 41% expect the renminbi to appreciate following liberalisation, while 31.5% expect China’s currency to weaken as domestic savers try to diversify their holdings abroad. This reflects a good deal of uncertainty among investors both offshore and onshore about the likely movement of the renminbi as the capital account opens (Figure 7).

All told, 41% of non-Chinese IIs expect financial liberalisation to lead to a slowdown of the Chinese economy, compared with just 27% of
domestic respondents (Figure 8). Although a greater proportion of foreign IIs expects financial liberalisation to encourage growth within the economy, a substantial minority expects a slowdown, emphasising the underlying scepticism about the competitive strength of the Chinese economy—and the risks of not following through with reform.

“There needs to be a proper financial system in order to fund the next Chinese growth story, and the government has indicated that it is their intention to open the financial system to global markets,” says Mr Lunt. “The costs of reversing policies would be high, potentially locking China out of the global financial system for decades.”

More than half of all respondents expect the Chinese currency to eventually surpass the dollar as the world’s largest reserve currency. China-headquartered respondents are more optimistic, with 62% saying that the renminbi will one day supersede the dollar, but a significant proportion (43%) of non-Chinese institutions also agree with this assessment (Figure 9).

Only 11% (or 22 respondents) say that they do not expect the renminbi to become a major reserve currency, split between 16 outside China and six onshore. Among the former, the most often cited reasons are that the renminbi will never enjoy enough liquidity across all asset classes to offer a viable option as a reserve currency, and that people will not trust the renminbi as a store of value. The very few pessimists from China-headquartered institutions, meanwhile, say that people would be concerned about future policies of the Chinese government and opposition from other economic powers, such as the US, the EU and Japan. But the consensus is that one day it will be a redback, rather than a greenback, world.
The survey results concur with other informed opinion in suggesting it will be some years before China fully internationalises its currency and opens up its financial system. In the meantime, there will be increasing focus on the development of the offshore market and the further steps China will take to cultivate this in anticipation of full renminbi liberalisation. The survey therefore asked IIs about their expectations for the development of the offshore market, focusing on why IIs would seek exposure to renminbi products, what they intended to buy (and sell) over the next 12 months and—in the longer term—which offshore centres were best placed to succeed.

**Why?**

Expectations of continuing renminbi appreciation play a much larger role in China-headquartered investors’ exposure to CNH products than that of foreign-headquartered institutions. Some 62% of China-headquartered IIs say they wish to gain exposure to CNH in order to profit from renminbi appreciation, compared to 39% of their foreign counterparts (Figure 10).

<table>
<thead>
<tr>
<th>Reasons for gaining exposure</th>
<th>China IIs</th>
<th>Non-China IIs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Currency appreciation</td>
<td>62</td>
<td>39</td>
</tr>
<tr>
<td>CNY:CNH Arbitrage</td>
<td>49</td>
<td>32</td>
</tr>
<tr>
<td>Serve Chinese HNWI with assets abroad</td>
<td>48</td>
<td>34</td>
</tr>
<tr>
<td>Market positioning</td>
<td>52</td>
<td>44</td>
</tr>
<tr>
<td>Portfolio diversification</td>
<td>46</td>
<td>36</td>
</tr>
<tr>
<td>Simplify cross-border investment</td>
<td>25</td>
<td>19</td>
</tr>
<tr>
<td>Not interested</td>
<td>14</td>
<td>3</td>
</tr>
</tbody>
</table>
The prospect of further renminbi strength is still nonetheless a key reason for foreign investors to gain exposure to the currency. “We’ve had about a 2.7% appreciation since the end of 2012, which on top of a 4% yield on the [offshore bond] market makes this quite an attractive proposition,” says Mr Lunt, adding that he expects this trend to continue over the next several years.

Meanwhile, arbitrage between offshore and onshore (CNY) renminbi rates inform 49% of Chinese institutions’ investment decisions, compared with 32% of foreign respondents, reflecting the greater expectation of currency volatility among China-headquartered companies. Arbitrage opportunities are also more valuable to larger institutions (over US$5bn in AUM), reflecting the continued difficulties for smaller foreign investors to access China’s domestic market.

China-based respondents are also eager to provide access to offshore products for domestic customers, with 48% of respondents saying they are investing in offshore renminbi in order to service Chinese high-net-worth individuals with assets outside the mainland, compared with 34% of foreign respondents with the same aim. This reflects the extent to which Chinese investors have been underserved by current CNH investment and repatriation options such as dim sum bonds or RQFII. Offshore deposits have skyrocketed since the introduction of the offshore trade settlement in 2009, with approximately 30% of the Rmb2.5trn offshore sitting in Hong Kong bank accounts earning low yields. Chinese institutional investors who have existing relationships with Chinese trading companies have an obvious interest in improving the performance of these assets.

“The demand for dim sum bonds is largely driven by the accumulation of offshore renminbi deposits, which are likely to continue to increase in step with the further liberalisation of the currency and the growth of international trade settlement transacted in renminbi. Deposit holders need financial instruments in which to invest,” says Mr Gui.

China-based investors are also more interested in purchasing offshore assets in order to diversify their portfolios (46% versus 36% for foreign respondents), and to ease the process of cross-border investment (25% versus 19% respectively).

What?
China-headquartered respondents express more interest in expanding renminbi holdings across all asset classes except offshore derivatives, where 43% of them say they plan to keep their exposure the same over the next 12 months, compared with 23% of foreign respondents—perhaps reflecting the relative underdevelopment of these products in mainland markets. The largest difference is seen in both CNY and CNH denominated equities, with 40% of China-headquartered respondents saying they would increase exposure to CNY equities in the next 12 months, and 38% saying they would increase exposure to CNH equities, compared with 25% and 19% respectively for offshore respondents (Figure 11).

Respondents seeking to increase their exposure to offshore equities express particular interest in selling to high-net-worth individuals with assets outside the mainland, while IIs looking to increase their exposure to onshore equities cite currency appreciation as their principal objective. In general, this correlates with the optimistic view China-based institutions have of the Chinese economy, as reflected in their more positive view of the impact of liberalisation and the renminbi’s future role in global currency markets.

The survey shows significant pent-up demand for QFII quotas, with 52% of IIs that currently lack them saying they will apply for a quota in the
next 12 months, compared to 43% that say they will be applying for a QDII quota and 42% saying they will be applying for a RQFII quota. Despite the faster expansion of the QFII programme in recent months, China has been more cautious on this side than with other schemes, with only US$10.55bn in new QFII quotas introduced in the last quarter of 2013, compared with US$22bn in QDII quotas and Rmb80bn (US$13bn) in RQFII quotas.

Where?
In 2013 China took several steps to broaden the means through which investors could gain exposure to renminbi-denominated securities offshore. In October, China signed agreements with London and Singapore to make them the first two cities outside Hong Kong to be able to participate in the RQFII scheme, under which offshore renminbi funds can be invested in onshore markets, with quotas of Rmb80bn
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(US$13.2bn) and Rmb50bn respectively. Also in 2013 Hong Kong’s RQFII quota was increased to Rmb270bn.

Then in September the government launched the Shanghai FTZ, with plans announced to allow foreign companies with subsidiaries in the zone to issue renminbi-denominated bonds, and to purchase onshore equities and bonds. Chinese companies based in the zone will similarly be allowed to purchase overseas financial products once the reforms are completed.

Despite delays in implementation, respondents express a wide degree of optimism about the Shanghai FTZ, with 21% saying that they expect Shanghai (or other not-yet announced FTZs) to see the fastest growth in offshore-renminbi portfolio trading over the next three years, second only to Hong Kong—which 41% of respondents see as likely to maintain its dominance (Figure 12). With China shortly to finalise details of a mutual fund recognition scheme with Hong Kong, the territory’s position as principal offshore centre for renminbi-product trading—and one of the fastest-growing—looks unlikely to be rivalled soon.

Perhaps unsurprisingly, foreign-headquartered IIs expect significantly more growth abroad, with 49% saying growth will be fastest in Singapore, Taiwan, London or New York, compared with 27% of China-headquartered respondents with that view. Offshore respondents are particularly optimistic about the prospects of Singapore, with 19% saying they expect growth to be fastest there over the next three years—more than the number of foreign investors who put Shanghai top. By comparison, only 8% of Chinese IIs expect Singapore to see the fastest growth in renminbi portfolio trading over that time period.

Part of this may be due to the time horizon. Financial centres further afield still work closely with Hong Kong, where most renminbi clearing takes place, while targeting renminbi-business growth among local companies. “London's growth as an offshore-renminbi trading centre is complementary with other offshore centres. We’re looking at services in London for businesses that are operating in the UK and the rest of Europe,” says Mr Boleat, noting that he expects growth to go hand in hand with the expansion of the Chinese economy. “London is already the largest international foreign exchange centre in the world, and China is a very
rapidly growing economy, so it’s a question of putting the two together.”

While there have been delays in the implementation of new financial policies in the Shanghai FTZ, there is broad consensus that expanding Shanghai’s role in offshore renminbi markets is a major objective of the Chinese government. “Support for Shanghai becoming an international financial centre [is one of the main initiatives carrying forward China’s reform agenda,” says Shiming Tan, Asia Pacific head of renminbi products at Citi Markets. “The reform will help China adopt global standards and... link onshore and offshore markets.”

Despite providing some competition with offshore financial centres, growth of the Shanghai FTZ is seen as a positive for offshore markets because it signals continuing commitment from the Chinese government towards liberalisation and efforts to expand access to the renminbi market overall. “New onshore trading schemes such as the Shanghai FTZ are important parts of renminbi internationalisation, and will contribute to the development of offshore trading centres,” says the Bank of China representative. “Apart from the direct impact of those trading schemes, their introduction indicates China’s regulators’ positive attitude towards renminbi internationalisation.”

Nevertheless, the Chinese authorities are likely to proceed cautiously. “There are strict regulations governing offshore renminbi bond issuance by mainland firms who might want to take advantage of lower borrowing rates, and this is so that onshore policies to address inflation and economic overheating concerns can be more effectively carried out. For the same reason, repatriation of renminbi proceeds from dim sum bonds raised by foreign firms operating in China is also tightly regulated,” says Clifford Lee, managing director and head of fixed income at DBS.

“Such regulations, although necessary, will naturally inhibit a faster-paced development of the offshore renminbi bond market,” Mr Lee adds. “The authorities are likely to maintain this cautious policy to grow this market at a more measured pace, which can be healthier in the long run, despite the preference of some potential issuers and investors keen for greater market depth presently.”
Despite a number of continuing obstacles to full renminbi liberalisation, there is currently broad consensus among IIs that China is committed to opening up its capital account to international flows. Future iterations of this survey, after further steps along the road to this goal have been taken, may show IIs are far less bullish about prospects for a “redback world” — particularly because it remains to be seen how Chinese institutions will meet the challenges of competing in global markets, or how this reform will affect SOEs.

Outside of China, this research shows the current expectation is that the Chinese government will be forced to privatise banks in order to create a financial system less subject to political goals and more able to compete internationally. “Chinese banks are not like banks in other countries, they benefit substantially from artificially low rates on deposits, and a lot of their loans are to state-owned enterprises,” says Mr Boleat. “If Chinese banks start losing deposits because there is more competition they will have no choice but to change their approach to both raising money and to lending.”

Within China, there is more concern about the political obstacles to reform and, consequently, more desire to see regulators deal with underlying systemic risks in the banking system prior to exposing Chinese banks to international market competition. China-based respondents see an urgent need for the introduction of a deposit insurance system, better risk-management tools and tightening up of China’s fiscal system, rather than opening the market and increasing financial sector competition.

While asset managers warn that there will be greater market and currency volatility as China reforms proceed, over the short-term there are plenty of opportunities for investors and asset managers, whether they want to profit from the process of market opening or set themselves up to capture the growing pool of Chinese investors and businesses that will have access to offshore markets.

“In a time of significant volatility in emerging markets, particularly large emerging markets such as Brazil and India, [offshore renminbi] has remained a fairly steady story that has delivered very good risk adjusted returns, possibly the best performance of any emerging market bond market in local currency terms,” says Mr Lunt. He adds: “It is [also] part of a bigger story; the opening up of the Chinese market as a whole. The opportunities as renminbi markets open to foreign investors will grow very substantially.”
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