

The shanghai free trade zone: interest rate strategy assignment

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The Shanghai Free Trade Zone. ?????? Interest Rate Strategy BY kh569356
CNH: Onshore deregulation, offshore expansion september 30, 2013 Interest rate strategy DBS Group Research 30 september 2013 The Shanghai Free Trade Zone (SFTZ) opened on 29 Sep. According to the blueprint, financial innovations including RMB convertibility and interest rate liberalization are the priorities on the reform agenda (see “ Shanghai Free Trade Zone & the reinvigoration of China”, 26 Sep 2013). These reforms will make the RMB an increasingly important currency in the global FX market.

However, some worry that the establishment of SFTZ will undermine the development of offshore RMB markets. Such fear is unwarranted. Looking at the Eurodollar market could help shed light on how offshore market grows in spite of onshore deregulation. Experience from the Eurodollar market During the 1960s, changes in US regulations such as reserve requirements, interest rate restrictions, and borrowing limits made offshore banking more attractive to local banks. Consequently, USD liquidity migrated to London, where non-US banks were not subject to regulation by the Federal Reserve. The Eurodollar market grew rapidly as a result.

The Eurodollar grew rapidly even after US capital controls and key taxes were lifted In the late-1980s and early-90s, most of the aforementioned regulations were eliminated. For instance, the Federal Reserve lowered reserve requirements on large- denomination domestic deposits to zero; in effect removing that tax' on local intermediation. But the Eurodollar share of global dollar banking had grown from 10% in 70s to 20% in 90s and over 30% in mid-2000s. Non-US residents continued to hold the majority of their

dollar offshore, and so did the official holders of dollar reserve (mostly overseas central banks).

During the 2000s, more than 70% of official dollar reserves was placed outside the US (Chart 1). And interestingly, LIBOR is the benchmark for today's US corporate borrowing. The sustainable growth of the Eurodollar market can be attributed to a number of non-US lenders and non-US borrowers of dollars (also known as thirdparty intermediation). Chart 1: Overseas official USD deposit by location USD bn

Year	US	Offshore
2004	268.2	269.4
2008	250.0	200.15
2010	73.0	59.7

Nathan Chow (852) 3668-5693 om For example, the central bank of UAE deposits USD10 mn in a London bank, which then lends the funds to a Mexican oil importer. In this case, the dollars might go through one or more offshore interbank transactions that could take place in London or other banking centres. But it does not require either sourcing funds or deploying funds in the US. Indeed, a significant portion of offshore dollar banking corresponded to such third-party intermediation. As of Jun10, of the USD4.9 trn total claims booked offshore, USD2.7 trn (or 55%) were claims on non-US residents (Chart 2).

Convenience difference might explain the market participants' preferences for offshore transactions. Chart 2: Consolidated global USD bank balance sheet (Jun 2010)

Category	Value (USD bn)
Banks outside the United States vis-vis non-banks	
Assets	2,246
Loans	1,086
Of which: to US residents	588
Liabilities	1,465
Deposits	2,621
Of which: from US residents	519
Total claims offshore	4,867
Total liabilities offshore	4,108
Of which: on	

US residents The Eurodollar market has primarily performed offshore intermediation among non-US residents 1, 491 (USD bn) Another motive is to separate currency risk from country risk.

In September 2001, for instance, the trading of US Treasury securities was interrupted due to terrorist attacks. But overseas central banks with dollar securities held in European depositories were still able to carry out normal operations. That reminds official reserve managers the potential benefits of having diverse trading and custodial locations. Other factors contributed, too. Volumes of literature have pointed to the Soviet Union's placement of dollar deposits in London as one of the origins of the Eurodollar market.

Middle East oil exporters also preferred to keep their oil revenues outside the US for various reasons. Implications for offshore RMB markets Judging from the dollar experience, global investors prefer to transact in a particular currency through the offshore markets. With respect to the RMB, the offshore market in Hong Kong (and in other financial centers) can be expected to evolve along the paths of the Eurodollar counterpart. Specifically, there is always a demand for separating currency risk from country risk amid concerns over concentration of infrastructure or operational risk in one Jurisdiction.

This is especially so in China. Notwithstanding encouraging improvement, Shanghai ranked but 21st in AT Kearney's 2012 Global Cities Index (Hong Kong, Singapore, and London ranked 5th, 11th, and 2nd respectively). This suggests the municipality has yet to become a world-class city in terms of business activity, human capital, information exchange, and cultural

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experience. Foreign investors are also highly sensitive to changes of political atmosphere in the mainland, which is in transition towards a market economy amid fierce resistance from vested interest group.

Any severe domestic volatility has the potential to force sweeping governmental actions; including financial reform. 2 Against this backdrop, investors need alternative venues to diversify their RMB exposures. The growing appetite for dim sum bonds of overseas institutional investors (including central banks), some of whom already have access to the mainland bond market (through QFII scheme), can be seen as a result of such risk- Dim sum bonds, notably, are being issued by not only mainland entities but also multilateral companies as well as international institutions, such as the World Bank and the Asian Development Bank.

This underscores the fact that the offshore RMB market is, to an increasing extent, functioning as a platform for RMB financial activities conducted among non-Chinese residents. Renault, a French automaker, sold a three-year dim sum bond earlier this year, 45% of which were taken up by investors outside of Hong Kong. The offshore RMB market is, to an increasing extent, functioning as a platform for RMB financial activities conducted among non-Chinese residents. Meanwhile, banks in Hong Kong are extending RMB credit lines to customers.

The outstanding RMB loan stands at RMB88 bn, from virtually zero three years ago (Chart 3). Such rapid growth of financing activities are the result of several encouraging policies, including allowing non-residents to borrow RMB (see “ CNH: More than just “ non-resident conchart 3: Offshore RMB loan

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outstanding version", 13 Aug 2012) RMB bn and liberalizing banks' RMB net open positions and statutory liquidity requirement. The Treasury Markets Association also introduced CNH HIBOR fixing recently.

This provides a benchmark to price loan facilities and facilitates the development of offshore RMB interest rate swap market. As the market deepens and a greater variety of RMB products become available, more RMB intermediation within the offshore markets will be seen. Adding borrowing in the RMB going forward will be less discouraged by the previous one-way expectations on the exchange rate. Other offshore RMB centers also possess respective long term edges.

Singapore, as a gateway to ASEAN and a commodities hub, could facilitate RMB-denominated trade across the region. For instance, an Indonesian mining company may settle its trade with a Malaysian customer in RMB as long as doing so enables them to lower transaction costs or manage currency risks better. In 2012, ASEAN surpassed Japan to become China's No. 2 importing region (Chart 4). The RMB liquidity generated from trade flow, alongside the RMB acquired from swap lines signed with Beijing, could potentially be used in third-party transactions (see "CNH: Singapore and Taiwan style", 19 Feb 2013).

Likewise, London, the largest handler of the world's RMB payments outside China and Hong Kong, can develop a "western RMB hub" by facilitating thirdparty use in the pan-European region. Given the significant difference in time zone, London's role is complementary to Hong Kong and Singapore by allowing longer trading hours for businesses in EMEA (Europe, the Middle

East and Africa) and beyond. 3 Chart 4: ASEAN surpassed Japan as China's No. import source USD mn 250, 000 China's imports from ASEAN China's imports from EIJ 200, 000 China's imports from Japan 1 50, 000 Singapore and London could facilitate third-party RMB use ASEAN and Europe respectively 1 00, 000 50, 000 2001 003 2005 2006 2007 2009 Conclusion Historical experience has shown that onshore deregulation did not interrupt the growth of the offshore markets. Non-US residents, private and official alike, reveal strong preference for doing dollar business in the Eurodollar market.

Such behavior prevailed even after US capital controls and key taxes were lifted. Third-party intermediation has since become the norm for the Eurodollar market. An inference is that the offshore RMB markets will increasingly play a similar role of intermediating among non-Chinese residents. The benefit of such positioning can persist in the long term, even when the RMB becomes convertible. References Dong He and Robert McCauley (2010): "Offshore markets for the domestic currency: monetary and financial stability issues" BIS Working Papers No. 320.

Dong He and Robert McCauley (2012): "Eurodollar banking and currency internationalization" BIS Quarterly Review, June 2012. 4 Recent Research 26 sep 13 US Fed: too hot to trot? 24jun 13 CN: Shanghai Free Trade Zone & the reinvigoration of China VN: At easing's end 21 Jun 13 TH, ID, PH: Roadmap to 2020 18 Jun 13 US: A pre-FOMC pulse-check 16 sep 13 Qtrly: Economics-Markets-strategy 3Q13 13 Jun 13 Qtrly: Economics-Markets-strategy 4Q13 2 sep 13 Asia property: How high the moon? US unemployment: call off the

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