

The ‘Belt and Road’ Initiative and the London Market – the Next Steps in Renminbi Internationalization

Part 3: Framework for Policy Discussion

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Introduction

Over the past 18 months, the internationalization of the renminbi, China's currency, has entered a new phase. Lower interest rates in the onshore renminbi market, combined with slower economic growth in mainland China and expectations of currency depreciation in the medium term, have caused the expansion of the offshore renminbi bond market to slow dramatically (in some quarterly periods, bond issuance has even contracted). This is despite the progressively greater opening of the Chinese capital account, increased interconnectedness between the onshore and offshore markets, and the addition of the renminbi to the IMF's Special Drawing Right (SDR) basket.

The Chinese government's outward investment agenda is feeding into currency reform prospects. In late 2013 the government announced the so-called 'Belt and Road' initiative, commonly known in the West as 'One Belt, One Road'. This initiative aims to promote infrastructure development in 60 countries in Asia and surrounding regions. However, it also has implications for the internationalization of the renminbi. Over the past several months, a team of seven researchers (see 'About the Authors') at Chatham House and the Chinese Academy of Social Sciences (CASS) has studied the feasibility of using this initiative as a means to expand the use of the renminbi, both in the real economies of Belt and Road host countries and in the London offshore financial market.

Investment in infrastructure in developing countries will need to increase from approximately US\$0.8–0.9 trillion per year in 2008 to approximately US\$1.8–2.3 trillion (at 2008 constant prices) per year by 2020. This works out at a gap of approximately US\$1 trillion between the level of 2008 and that of 2020.¹ Based on these estimates, the authors argue that the Belt and Road initiative can help fill that gap and provide ample opportunities for increasing use of the renminbi outside China. The internationalization of the renminbi in the real economies of the countries concerned will require greater external circulation and third-party use. Belt and Road activity is likely to contribute to this by incentivizing the use of the renminbi by local corporates operating in host countries. Meanwhile, issuance of renminbi-denominated debt by these corporates will encourage greater circulation of renminbi in offshore markets, in particular in bond markets.

The greatest obstacle to the development of offshore renminbi markets remains their lack of liquidity. This could be addressed by issuing renminbi-denominated debt financing instruments linked to Belt and Road projects. This would also help to ensure that currency internationalization in the real economy will not cause excessive shocks to the domestic financial markets of participating countries.

To support this initiative, the authors have identified a series of 16 policy recommendations detailing how the Chinese and British governments, in collaboration with private banks and investors based in the City of London and worldwide, can effectively support the development of Belt and Road financing in such a way that it expands the use of the renminbi in both the financial and real economies. These recommendations can broadly be divided into five categories: providing policy guidance, expanding

¹ Liu, D., Gao, H., Xu, Q., Li, Y., Shuang, S. (2017), *The 'Belt and Road' Initiative and the London Market – the Next Steps in Renminbi Internationalization, Part 1: The View from Beijing*, Research Paper, London: Royal Institute of International Affairs.

the offshore renminbi bond market, developing other offshore renminbi products, developing other offshore renminbi market infrastructure, and identifying priorities for Sino-British cooperation. While it may be possible to implement some of these recommendations in the next one to three years, others are likely to be longer-term ambitions that will have to be synchronized with further growth and development in the Chinese economy and offshore renminbi market.

Policy Recommendations

Providing policy guidance

1. Official guidance is needed from the Chinese government on its strategy regarding the use of the offshore renminbi bond market for the purposes of financing the Belt and Road initiative.

The Belt and Road initiative provides an opportunity for greater issuance of renminbi-denominated bonds on the global market, and thus for an expansion in the international use of the renminbi. Chinese corporates involved in manufacturing and construction will benefit from the Belt and Road initiative. They will be encouraged to go abroad to deliver Belt and Road projects. The offshore issuance of bonds denominated in renminbi can provide a source of international financing for these corporates. The supply of offshore bonds is currently low, because lower interest rates make the onshore market more attractive to issuers. However, Chinese corporates may be incentivized to issue debt offshore if the transaction costs involved in conducting renminbi business offshore are lowered on the back of the Belt and Road initiative and the potential consequent increase in the number of corporates in the real economy outside China doing business in renminbi.

The Chinese government and the associated policy banks that it has empowered, such as the Export-Import Bank of China (China Exim Bank) and China Development Bank, could support the offshore issuance of bonds for Belt and Road financing. They could do this by issuing guarantees, or by issuing the bonds directly themselves. This process could be made easier if the Chinese government provided official encouragement and guidance on how it plans to support the issuance of debt in the offshore market.

2. Official guidance is needed from the Chinese government on how it views the future of the offshore market in the context of the increasing liberalization of the onshore market.

At the moment, many international investors still see the offshore market primarily as a hedge, substitute or arbitrage opportunity against the onshore market. While currencies such as the US dollar and euro have thriving offshore markets without capital controls, these exist in the context of stable regulatory environments for both offshore and onshore markets. China could try to provide a more specific position on its preferred 'final state' of the offshore market, so that investors can more realistically assess the prospects for potential long-term investments in the offshore market.

Expanding the offshore renminbi bond market

3. Renminbi-denominated bonds issued by Chinese policy banks in the London offshore market with tenors of 10 years or longer are needed to create a benchmark and allow the market to develop.

At the moment, the market for offshore renminbi bonds with a tenor of 10 years or greater is virtually non-existent. The establishment of a yield curve for bonds of such duration is necessary for a market for infrastructure financing to develop, given that infrastructure projects typically require financing structured with long time horizons. Chinese policy banks are obvious candidates to take the lead in creating a market for 10-year or longer-dated bonds in the offshore market – they have already issued such instruments in Hong Kong, and their involvement would signal the Chinese government's support for such an endeavour. It would also support the activities of China Development Bank and China Exim Bank in Belt and Road regions. This process will take time to develop in London. Ideally, the policy banks would coordinate with other international development banks and Chinese corporates to provide a diversity of issuances.

4. Local Chinese governments could be encouraged to develop the capacity to issue renminbi-denominated debt in London.

Currently, Chinese issuers of 'dim sum bonds' – as offshore renminbi-denominated bonds are commonly known – are limited to the Chinese central government, large financial and non-financial corporates, and two Chinese policy banks, China Development Bank and China Exim Bank. Chinese provincial and municipal governments have not yet issued debt offshore. Most provinces in China are equivalent in size to a medium-sized country in Europe, and enjoy credit ratings equal to or higher than those of China's large corporations and financial institutions. These local governments could be encouraged to issue bonds in the offshore market. Adding Chinese local governments to the list of Chinese firms and organizations issuing debt in London will further expand the pool of issuers of renminbi-denominated debt worldwide. This initiative will also accelerate the establishment of more standardized, legalized and prudent fiscal practices on the part of Chinese local governments, which will have to abide by international standards to issue debt successfully on international markets.

5. British and Chinese authorities could encourage the development of a secondary market for renminbi bonds in London.

As the volume of renminbi-denominated bonds grows in London, the Chinese and British governments should ensure that a secondary market develops. At the moment, due to the low volume of bonds issued, the secondary market is virtually non-existent. The presence of a secondary market is particularly important for bonds with long durations: these instruments are especially illiquid, and investors will be more willing to buy them if they can be resold. There have been very few moves in this direction so far. In June 2015, the People's Bank of China (PBoC) allowed renminbi clearing and settlement banks that participate in the interbank bond market to access the onshore interbank market for short-term loans. However, this facility was suspended in November 2015. It could be revived, and its use should be encouraged. If the market does not develop organically, China may have an interest in providing a similar facility for the bond market, or in having policy-led banks and funds such as the Silk Road Fund act as market-makers, guaranteeing liquidity in sufficient volume until the market can become self-sustaining.

Developing other offshore renminbi products

6. Banks could explore the potential to develop renminbi-denominated securitized assets in London.

The existing pool of offshore renminbi assets can be more effectively developed if more illiquid assets are securitized. This is particularly true of renminbi-denominated Belt and Road financial instruments, which are likely to be more complex than normal debt instruments. Long-term investors generally prefer relatively simple investments with clear returns in familiar areas. As a result, it will likely be easier to attract investors to infrastructure projects in Belt and Road regions if the cashflows from them are securitized. Renminbi-denominated securities would have to be relatively simple and transparent in their initial rollout to ensure investors were comfortable with the risks involved, but they could become more complex over time. The development of additional securitized assets in London would allow a wider range of investors to provide funding for Belt and Road infrastructure projects.

7. Banks and asset managers could explore the potential for issuance of offshore renminbi-denominated wealth management products in London.

In time, it may become feasible for Chinese banks to issue renminbi-denominated wealth management products in the London offshore market. This would serve three goals: widening the base of private investors for renminbi-denominated assets, buffering against the negative effects of Basel III regulatory requirements on long-term loans, and providing more extensive overseas renminbi-denominated asset options.

Two types of wealth management products could conceivably be issued in London. First, Chinese banks' wealth management products could be sold on a cross-border basis in markets such as London. This would simply extend the sales of domestic financial products outside Chinese territory. The main hurdles for this initiative would be the need for increased regulatory cooperation between Chinese and offshore regulators, and for greater harmonization of Chinese products with international standards.

If this first type of product were successfully developed, the second step would be to develop specific Belt and Road-related wealth management products in London. Such funds could be invested into the development of Belt and Road projects in the form of entrusted loans or debt securities. This would be another innovation combining renminbi internationalization with Belt and Road financing. The second category would involve more technical difficulties, but could be explored if the initial development of wealth management products gains traction.

8. Financial institutions could collaborate to establish an offshore renminbi investment fund in London.

Investment in Belt and Road countries could be accomplished more efficiently through a renminbi-denominated investment fund. Financial institutions in both China and the UK could cooperate with the Chinese government to set up such a fund in London, with a mandate to raise offshore renminbi and invest in Belt and Road regions. The fund would use public-private partnerships and other investments. Financial institutions in both countries (such as China Development Bank and China Exim Bank, and the UK's HSBC and Standard Chartered Bank etc.) could provide the principal funding for such a fund. Other market institutions could be invited to participate after the fund, which would be jointly governed by representatives from each of the stakeholders, became operational. This initiative could provide

a coordinated means for Western and Chinese investors to both promote the renminbi's circulation outside China and raise funds for investments in Belt and Road regions. Such a fund could take on additional mandates in the future, such as promoting 'green financing' along Belt and Road routes.

Developing other offshore renminbi market infrastructure

9. Liquidity provision via the swap agreement between the PBoC and the Bank of England should be expanded.

Lack of liquidity remains one of the greatest impediments to the growth of the London offshore renminbi market. As of January 2016, only RMB 50 billion (US\$7.2 billion)² in deposits were held in London, compared with over RMB 800 billion in Hong Kong, over RMB 300 billion in Taipei and over RMB 200 billion in Singapore. The current swap agreement between the PBoC and Bank of England is at a level of RMB 350 billion. If London is to expand as a hub for offshore financing in the volumes estimated to be required for the Belt and Road initiative, it will be necessary to sustain and probably expand this cap.

10. Access to an export credit agency or similar institution could be provided by the Chinese government to allow non-Chinese investors in Belt and Road projects to obtain political risk cover.

The Chinese government could provide a means of supplying political risk insurance for foreign investors by creating or empowering an export credit agency (ECA) or similar entity to cover Belt and Road financing for non-Chinese investors. Private financiers investing in foreign countries are generally funded by ECAs in their issuing countries. China's ECA, the China Export & Credit Insurance Corporation, also known as Sinosure, provides insurance for country risk in Belt and Road projects. However, Sinosure requires that at least 60 per cent of any project capital raised goes to Chinese entities, and that at least 70 per cent of financing is provided by Chinese banks. This limits the ability of international investors to gain political risk cover.

While other countries have ECAs, their mandates are not aligned with the objectives of the Belt and Road initiative, meaning that they are less likely to provide cover to private investors in Belt and Road countries. If certain political risks inherent in Belt and Road projects are not covered through some insuring entity, they may not be financeable at any yield.

By creating a Belt-and-Road-specific ECA, or empowering Sinosure to do so, the Chinese government could facilitate the financing of projects not otherwise considered 'bankable'. For political reasons, such an ECA may have to be co-financed or co-governed by a variety of international governments, as is the case with the World Bank's Multilateral Investment Guarantee Agency. The Asian Infrastructure Investment Bank (AIIB) could also be expanded to fill this role.

11. The renminbi cross-border loan scheme could be extended to London.

In January 2013, a pilot project for cross-border loans between the Qianhai Shenzhen free-trade zone (FTZ) and Hong Kong was expanded to all the other new FTZs in China. This also designated Macau and Singapore as permissible sources of renminbi funding. As of 30 June 2015, the amount of cross-

² Using an exchange rate of RMB 6.95:US\$1. Reuters (2016), 'Currencies Quote', 29 December 2016, <http://www.reuters.com/finance/currencies/quote?srcAmt=1.00&srcCurr=USD&destAmt=&destCurr=CN¥> (accessed 29 Dec. 2016).

border renminbi loans made to companies in the Qianhai FTZ had reached RMB 107 billion. London should be added to the cross-border loan programme in the next round of expansion. This would allow British borrowers and lenders to access all of the FTZs directly, and would expand liquidity in London. However, quota management would remain necessary in order to prevent cross-border renminbi flows from disrupting the domestic money supply in China.

12. The City of London and Chinese authorities could encourage greater cooperation and coordination between Chinese and UK stock markets.

In its 2015 annual report, the PBoC announced two liberalizing reforms of the Chinese stock markets: (1) it would allow foreign companies to issue shares on an 'international board' of the Shanghai Stock Exchange; and (2) it would also allow foreign companies to issue Chinese Depository Receipts (CDRs) in China. Both innovations will encourage cross-border activities in renminbi, which will further encourage its internationalization. The City of London could take advantage of these developments, encouraging listed companies in London to issue renminbi-denominated shares and CDRs in China's stock markets. This would help address the lack of renminbi deposits in London by increasing the flow of renminbi from China into London through stock market investment. Increased Sino-UK stock market cooperation could provide a crucial channel for the sustainable development of the London market. Increasing the volume of renminbi-denominated shares held in London would help to boost the inflow of renminbi-denominated financial assets from China to London, with benefits both for liquidity and the internationalization of the currency.

Identifying priorities for Sino-British cooperation

13. The British and Chinese governments could agree on and promote a set of universal cross-border principles for 'green bonds'.

The British and Chinese governments should establish a uniform set of 'green finance' principles, and a credible way to monitor projects' adherence to them, with the aim of applying this regime to Belt and Road host countries. Both governments are committed to the development of green bonds; and given the typically long time horizons of infrastructure projects, many Belt and Road projects will become infeasible if they are not certified as green. More stringent global standards on greenhouse gas emissions were agreed at the COP21 climate conference in Paris in 2015; in light of the targets set, investment in polluting forms of infrastructure such as coal projects or oil pipelines will become less attractive in relation to infrastructure projects that emphasize sustainability.

The UK and China are significantly ahead of Belt and Road host countries in the development of green finance principles: many Belt and Road countries lack high standards of transparency on these issues, and there is little consistency between regimes. If each country has different standards for green investment, this will raise compliance, rating and verification costs, as each project will have to be certified multiple times. A coordinated verification framework is therefore needed.

14. The British and Chinese governments could promote 'triangular cooperation' in the Belt and Road region.

'Triangular cooperation' is a form of development cooperation involving a traditional donor, an emerging market donor and a developing-country beneficiary. Triangular cooperation has been

increasingly encouraged by the UN, World Bank and other multilateral institutions since about 2008 – most notably in the 2010 Bogota statement on South–South Cooperation and Capacity Development and the UN secretary general's 2010 report on international cooperation.³ During Premier Li Keqiang's visit to France in July 2015, China and France issued a joint statement on triangular cooperation – this marked China's first signing of an official triangular cooperation agreement with a developed country.

We propose that China also actively develop a triangular cooperation strategy with the British government, focused on the promotion of economic cooperation with Belt and Road host countries. Areas of triangular cooperation could include joint investment, joint research, joint training and so forth. This would make use of the UK's financial and high-tech advantages, including experience in overseas investment, thus reducing investment risks in Belt and Road projects. At the same time, triangular arrangements would showcase the potential of the Belt and Road initiative to become in effect an 'open platform' in which all countries could participate, and a benchmark for top-level cooperation between China and developed countries in jointly promoting global aims.

15. The Chinese and British governments, the City of London and industry groups could actively support co-financing and partnerships between British and Chinese firms.

The Chinese government has said that it expects to finance the Belt and Road initiative through a mixture of domestic and foreign investment. It is common in project finance to develop co-partnerships to allow organizations with greater experience in project delivery to bear the completion risks – implementing parties can take on the risks of implementing the project, while investors can provide the capital at a reasonable interest rate. It is also common for foreign firms to undertake M&A activities in local countries to acquire the local expertise necessary for successful project delivery. Beyond debt financing relationships, many such arrangements may take the form of equity partnerships. The relative merits of different arrangements can only be determined on a case-by-case basis. However, due to the extensive cross-border collaboration necessary, it will be necessary for the Chinese, British and host-country governments to support co-financing arrangements in all their permutations.

16. British and Chinese stakeholders could sustain coordination on implementing the above recommendations.

The British government should coordinate between Chinese policy banks, international development banks, the City of London and private investors to encourage greater issuance of renminbi-denominated bonds and project bonds with maturities of 10 years or more. Many actors, particularly in the private sector, are unclear on the likely policy direction of the Chinese government as the onshore market opens up. Additionally, the change in leadership in Westminster after the EU membership referendum has created uncertainty about the UK government's priorities in developing the London offshore market. Finally, the creation of the new instruments and market infrastructure proposed above will involve coordination among multiple actors.

³ Ashoff, G. (2010), 'Triangular Cooperation: Opportunities, risks, and conditions for effectiveness', World Bank Special Report, 2010, <http://siteresources.worldbank.org/WBI/Resources/213798-1286217829056/ashoff.pdf>.

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