

Analysis of Hong Kong's financial market advantages and its new development as a global RMB offshore financial market

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Abstract. The establishment and development of an offshore RMB financial market has far-reaching implications. As an important component of China's offshore financial market, Hong Kong's RMB offshore financial market is an objective prerequisite for China's long-term financial liberalization and the establishment of a new "double-loop" development model. Although Hong Kong's offshore RMB financial market has made great progress in the past decade, there are still some shortcomings. This paper analyzes the development trend of Hong Kong's offshore RMB from the perspective of the characteristics and advantages of Hong Kong's RMB offshore market, and identifies the problems, and then discusses the development direction and focus of Hong Kong's offshore RMB.

1 Introduction

Since the 19th Party Congress put forward the strategic policy of "promoting the formation of a new pattern of comprehensive opening up and adhering to the equal emphasis on importing and going out", China's financial market is accelerating its opening up to the bilateral market. The development of offshore financial markets has become an important part of RMB internationalization and an integral part of China's financial sector opening 1.

As early as 2003, the People's Bank of China approved the Bank of China in Hong Kong as a clearing bank to provide RMB-related settlement services in Hong Kong, and in 2009, with the approval of the State Council, Hong Kong officially launched a pilot scheme for cross-border RMB transaction settlement. The PBOC, together with relevant departments, has issued a set of policies, including: opening up RMB direct investment in RFDI abroad, launching RQFII for foreign RMB foreign institutional investors, and promoting investment in the domestic inter-bank bond market by three types of institutions outside the country. Although RMB business in Hong Kong has been developing steadily, the relative fragmentation of RMB products at the time led to uneven development of the RMB market. This also led to a slowdown in the construction of Hong Kong's offshore market to promote RMB internationalization after the early steady development.

As the "super-contact" between Mainland China and the international market, the development of Hong Kong's offshore RMB market has a significant impact on the use and circulation of RMB and on the internationalization of RMB. To this end, this paper applies literature reading analysis and statistical methods to identify the advantages

and characteristics of Hong Kong's offshore RMB financial market, summarize its development trend and current situation, and use data analysis to explore the problems of Hong Kong's offshore RMB market based on primary and secondary data obtained from the Wind database, and then propose the bottlenecks of Hong Kong's offshore RMB market for its future development. In addition, this paper also use the data analysis method to explore the problems of the current Hong Kong offshore RMB market, and then propose the focus points for the future development of the Hong Kong offshore RMB market based on the bottlenecks.

2 Advantages of Hong Kong in building an offshore RMB financial market

2.1 Has a complete financial facilities and market management system

As an international financial center and an important hub for offshore RMB transactions, Hong Kong has a well-established financial system and diversified channels for cross-border capital flows. As early as 2007, Hong Kong established the RMB Real-time Full Payment System to enable banks worldwide to settle RMB-denominated bonds through Hong Kong. Among them, the establishment of three financial services platforms, namely the RMB Instant Payment System, the RMB Transfer Fast System Debt Instruments Central Clearing and Settlement System, has ensured that Hong Kong has achieved efficient and user-friendly settlement, delivery and custody services in cross-border RMB payment and settlement services, regional RMB payment services and RMB bond investment respectively.

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In addition, Hong Kong has the most liquid risk capital in Asia and a well-established regulatory framework that allows financial institutions to operate freely and with relatively lax and flexible regulation. The Hong Kong Monetary Authority issued an "Interpretation" in 2010, which clearly states that financial institutions in Hong Kong can refer to the rules commonly used in other currencies to conduct business after the introduction of RMB, thus creating a favorable market environment for the development of RMB products.

2.2 Has a good ecological environment for the use of RMB

Compared with other overseas RMB offshore transactions, Hong Kong has introduced RMB earlier and thus has a smoother RMB inflow and an offshore pool of RMB funds. With abundant RMB funds, rich RMB products, frequent RMB trading activities, and rapid development of RMB funds, insurance and derivative products, the RMB business ecosystem in Hong Kong is gradually taking shape. In addition, there are channels for RMB to be used outside of Hong Kong, changing the reliance on cross-border use of RMB. A survey by the Hong Kong Securities Commission shows that Hong Kong approved the issuance of 577 RMB investment products and managed RMB 204 billion in assets in 2021. Figures released by the Hong Kong Stock Exchange show that 2.356 million RMB futures and options were traded in 2021, with 24,000 contracts open at the end of the year. According to the Hong Kong Insurance Authority, new RMB insurance premiums reached RMB 5.86 billion in 2021.

2.3 The special advantages of "one-country-two-system" policy and the active cooperation of Hong Kong and Mainland governments on both sides of the border

As a special administrative region of China, Hong Kong has a certain degree of economic and political control over it and can promote the development of Hong Kong's RMB offshore market through its own policies. From the 12th Five-Year Plan to the 14th Five-Year Plan, the development of Hong Kong as an offshore RMB business center and the strengthening of its position as a global offshore RMB business hub have been continuously proposed [1]. In July 2022, the People's Bank of China,

the Hong Kong Securities and Futures Commission and the Hong Kong Monetary Authority jointly announced the interconnection of the interest rate swap system between Hong Kong and the mainland to facilitate the internationalization of the RMB [2].

The Hong Kong Monetary Authority has given full attention and strong support to the development of Hong Kong's offshore RMB business by continuously optimizing the central clearing system for debt instruments to provide efficient, secure and convenient settlement and custody services for participants in the RMB bond issuance and trading market in the Mainland. At the same time, Hong Kong has the advantage of "two systems" compared to domestic offshore RMB markets such as Shanghai, and the separation of Hong Kong and the Mainland is conducive to maintaining the relative independence of its offshore and onshore markets and reducing the adverse inter-market impact.

3 Development trend and status of Hong Kong's RMB offshore financial market

3.1 RMB deposit and loan growth has shrunk in scale

Since the "8.11 exchange rate reform" in 2015, under the expectation of RMB depreciation, a large amount of offshore RMB has flowed back to the domestic market, and the balance of offshore RMB deposits in Hong Kong has fallen sharply [3]. Since 2018, with the improving economic tone and stabilization of the RMB exchange rate, the operation of the "Shanghai-Hong Kong Stock Connect" and "Shenzhen-Hong Kong Stock Connect" mechanisms has led to a revival of offshore RMB activities in Hong Kong. The opening of the "Northbound Connect" has led to the development of the interconnection mechanism of the bond market infrastructure, driving a steady rebound in Hong Kong's offshore RMB pool. According to the Wind database, as of December 2022, the balance of RMB deposits in Hong Kong was RMB 835.903 billion (as shown in Figure 1), down 10.87% from the same period of the previous year, and in recent years, RMB deposits in Hong Kong have shown a fluctuating upward trend. As of September 2022, the balance of RMB loans in Hong Kong was RMB 177.9 billion (as shown in Figure 2), also down from the same period of the previous year.



Figure 1: Changes in RMB deposit balances in Hong Kong



Figure 2: Changes in RMB loan balances in Hong Kong

3.2 Steady growth in the volume of RMB trade settlement transactions

RMB showed growth in related cross-border trade, with the total amount of RMB trade settled in Hong Kong exceeding RMB 1 trillion, a significant increase from the previous year. Compared to the Mainland, the total trade

accounted for about 90%, indicating that Hong Kong plays an important role in handling cross-border trade as an international trade center. According to relevant statistics from the Wind database, as of September 2022, the total amount of RMB trade settlement in Hong Kong was RMB 67.77 billion, with a clear upward trend in recent years.



Figure 3: Changes in the volume of RMB trade settlement transactions in Hong Kong

3.3 Actively radiating RMB business to overseas regions

The Central Government supports Hong Kong to play an active role in the investment, financial and risk management aspects of the Belt and Road Initiative. Hong Kong will leverage its existing strengths as a global offshore RMB center to expand RMB services to other offshore regions and provide support for the development of other offshore RMB markets. In the future, the Mainland will continue to promote the Belt and Road Initiatives, establish FTAs with China and ASEAN to further deepen economic and trade cooperation with neighboring countries. By 2022, the RCEP agreement will come into force and Hong Kong will actively seek to join the RCEP and seek greater room for development to facilitate the development and expansion of Hong Kong's offshore RMB business.

4 The main problems of developing RMB offshore financial market in Hong Kong

4.1 Imbalance in the ratio of RMB deposits to loans, with large fluctuations

As of September 2022, banks in Hong Kong had a balance of RMB deposits of RMB 857.706 billion and a loan stock of RMB 177.9 billion, with an imbalance in the deposit to loan ratio [4] and the RMB deposit to loan ratio in Hong Kong halved this year compared to the level in 2017, indicating that the RMB loan creation in the Hong Kong financial system is insufficient and the deposit to loan ratio fluctuates significantly over time (as shown in Figure 4). This result is caused by the restricted access to RMB in Hong Kong's financial market, coupled with the impact of a series of public events since 2018, such as the US-China trade friction, the Fed's interest rate hike, and the new crown epidemic at the end of 2019, which has hampered the economic development of the Hong Kong region and sapped investment demand for the community, and the poor offshore RMB credit creation capacity in Hong Kong.

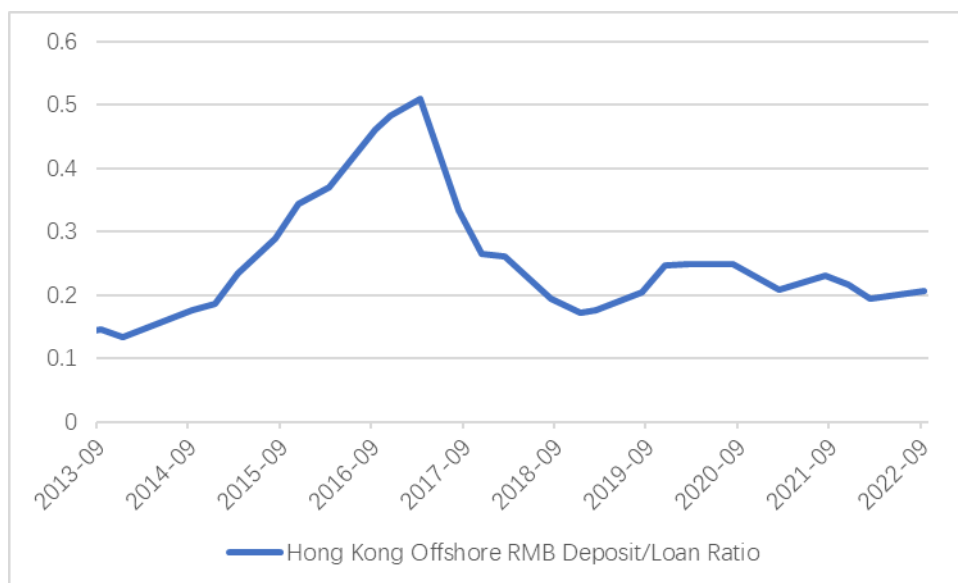


Figure 4: Changes in Hong Kong's Offshore RMB Deposit-to-Loan Ratio

4.2 Arbitrage drive is still the main investment motive

As early as February 2010, the HKMA issued a guideline stating that when RMB flows into the Hong Kong market in the future, it is free to conduct business in accordance with other currencies in the offshore market as long as no cross-border repatriation to the Mainland is involved, including the fact that offshore RMB may not be limited to trade settlement and banks are allowed to conduct bookkeeping and liquidity management of offshore RMB in comparison with offshore currencies such as USD. Therefore, the structure and mechanism of the onshore and offshore markets are very different in the early stage of RMB internationalization. The offshore market in Hong Kong was a highly mature market that was in line with the international operating system, while the onshore RMB was still in the initial stage of internationalization. There were inevitable differences in currency prices in the different markets, and market players would spontaneously choose according to the differences in the markets [5]. In such a market context, investment activities aimed at speculative arbitrage were fostered, and offshore investors in Hong Kong held RMB assets mainly for exchange rate appreciation and remittance income. Arbitrage traders always actively seek the spread between offshore and onshore financial instruments and buy low and sell high, which can have some impact on the RMB offshore financial market. Relatively few investors use RMB assets for long-term investments based on medium long-term real needs, so investors are less vulnerable to short-term exchange rate fluctuations and remittance volatility. As the market becomes more mature and the country opens up the onshore market to a greater extent, such as through the "Stock Connect" and "Bond Connect", the connectivity between the offshore and onshore markets continues to improve and the RMB exchange rate gap between the two places is narrowing, but the arbitrage phenomenon in Hong Kong's offshore

RMB market is still more pronounced. However, the arbitrage phenomenon in the Hong Kong offshore RMB market is still relatively obvious.

4.3 The unique RMB interest rate and exchange rate system leads to poor RMB liquidity

Hong Kong's interest rate and exchange rate system is very different from that of the Mainland. China has not yet established formal rules for RMB exchange rate formation, and lacks a benchmark interest rate for RMB and an intermediate price for RMB. As a result, there is a lack of reference prices for interbank lending and RMB loans, which constrains the supply of RMB loans, hinders the development of interest rate derivatives, and restricts the liquidity of RMB. At the same time, due to the special political and economic background of Hong Kong, the Chinese central bank is able to effectively control the RMB financial market in Hong Kong. After the "8.11 exchange rate reform", the RMB was under great pressure to depreciate against the USD. As a result, the Chinese central bank used the sale of foreign exchange reserves, capital outflow controls and countercyclical factors to stabilize the RMB exchange rate. While this played an important role in alleviating the depreciation pressure on the RMB in the current period, the central bank's regulation also had an impact on the degree of "offshoring" in the offshore market. In an offshore financial market that is entirely at the mercy of market supply and demand, the establishment of a sound system and sound financial regulations is the foundation. The central bank's involvement in the offshore market will certainly have an impact on the expectations of foreign investors, reducing the amount of capital outflows, resulting in a lower supply of offshore RMB funds, significantly increasing the difficulty for non-residents to access RMB funds, and thus restricting the healthy development of the offshore market.

5 Focus Points for the Development of Hong Kong's RMB Offshore Financial Market

5.1 Enhance the activity of offshore RMB financial transactions

Although Hong Kong's investment institutions have launched various types of RMB products, which have attracted significant investment from both domestic and foreign capital in Hong Kong's financial markets, the scope of RMB liquidity outside of Hong Kong still needs to be further broadened. To promote the use of RMB by global players in China's capital account and to further facilitate RMB cross-border investment and financing, an active offshore RMB center will serve as a hub to effectively connect domestic and international markets and facilitate the use and circulation of RMB until RMB is fully convertible. The offshore RMB center will serve as an effective hub to connect the domestic and international markets and facilitate the use and circulation of the RMB, thereby promoting the internationalization of the RMB until it is fully convertible.

To enhance the activity of the Hong Kong offshore market, the scope of the issuing entities of Hong Kong offshore RMB bonds can be expanded to include local governments, large institutions and multinational enterprises, and to a certain extent enrich the maturity types of offshore RMB treasury bonds, local bonds and central bank notes of the period to provide a basis for the pricing of various types of bond issuing entities; develop the bond repurchase market and establish a bond repurchase mechanism. The RMB treasury bonds held by overseas institutions also need a corresponding mechanism to support repurchase to obtain RMB liquidity, which will also improve the means of using RMB assets efficiently and enhance investors' willingness to hold RMB bonds. But try to avoid the implementation of high leverage ratio RMB products, in the Hong Kong RMB offshore market, RMB liquidity is poor, less investment, the launch of high leverage RMB products in this environment, easy to cause exchange rate fluctuations, thus leading to the lack of credit in the Hong Kong RMB offshore market [6]. Therefore, to ensure the stability of the Hong Kong offshore RMB market, it is necessary to avoid the introduction of highly leveraged currencies as much as possible until a currency liquidity regime is established.

5.2 Balancing exchange rate differences between the offshore and onshore markets

The RMB exchange rate system in the domestic market is very different from that in the foreign market, and there are differences between the two for the exchange and transactions of RMB, thus hindering the cross-border flow of RMB, which not only restricts the development of China's RMB offshore market, but also brings certain difficulties to the effective control and supervision of RMB capital accounts. Therefore, a strict division should be made between domestic and offshore capital, and the

fund dispatching of financial institutions operating foreign capital in the country and offshore branches operating domestic capital in the country should be classified as foreign exchange business and managed according to the standards of international foreign exchange funds [7]. Based on China's exchange rate and interest rate system, offshore RMB foreign exchange transactions are predicated on foreign exchange conversion, and the arbitrage formed by foreign exchange differences is unstable in the foreign exchange market. Therefore, when conducting foreign exchange transactions in RMB, foreign exchange in RMB must be classified as foreign capital, while foreign exchange capital in RMB is a kind of foreign capital, which can effectively prevent fluctuations in RMB exchange rate and interest rate.

5.3 Encourage the development of other capital markets

The spread between asset returns in the onshore and offshore RMB markets in the Mainland suggests that the return on RMB assets in Hong Kong is much lower than the return on RMB assets in the Mainland, in large part due to the lack of investment options available in the Hong Kong RMB market. With the growth effect of the intra-regional market formed after the RCEP came into effect, Hong Kong's offshore RMB market is gradually developing into a major provider of offshore RMB services to intra-regional countries, with intra-regional countries as its main target. Therefore, in order to reduce the impact of foreign capital on China's investment, other capital markets other than the Hong Kong RMB market need to be vigorously developed. Improving the development of the offshore RMB market in Hong Kong, establishing a sound asset circulation system, and promoting the regulation of foreign investment into the territory. At the same time, the government should also further improve the management system of the offshore RMB market in Hong Kong, enrich the variety of RMB products, encourage RMB investments by foreign capital holders, use RMB as settlement currency in import and export trade, and promote the process of RMB towards internationalization.

6 Conclusion

Hong Kong's offshore RMB market is a major achievement in the globalization of China's economy. Hong Kong's offshore RMB transactions have also been better developed with the full implementation of The Belt and Road Initiatives and the gradual improvement of the cross-strait communication mechanism. As a mature international financial center, Hong Kong's offshore RMB market has maintained a good momentum of development, riding on the east wind of cross-strait cooperation and mutual assistance, although the growth of its foreign exchange reserves and lending has begun to slow down, the volume of RMB trade settlement has maintained a steady growth in recent years, and in line with The Belt and Road Initiatives. Hong Kong is actively

expanding its RMB business to countries along The Belt and Road Initiatives.

However, due to the special political and economic environment of Hong Kong and the inherent defects of its financial market, there is an imbalance in the ratio of RMB deposits to loans of Hong Kong banks, the spread between offshore and onshore exchange rates leads to a large amount of arbitrage, and the macro regulation of the central bank limits the liquidity of RMB in its financial market. Regarding the future development orientation of Hong Kong's offshore RMB market, this paper argues that the structure and mechanism of the financial markets on both sides of the Taiwan Strait should be balanced in order to broaden the investment motive of Hong Kong's offshore RMB market and enhance the liquidity of RMB abroad; expand the issuing entities of RMB bonds and develop the bond repo market to enhance the activity of offshore RMB financial transactions; encourage the development of other capital markets to make up for the social investment demand. The development of other capital markets will be encouraged to make up for the inadequacy of social investment demand and lay the foundation for the prudent promotion of RMB internationalization.

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