

**MONTHLY HIGHLIGHTS**

- Compared with September 2016, TR/HKEX RXY Global CNH Index fell by 0.28 per cent to 94.97, while the People’s Bank of China (PBOC) USD/CNY Fixing increased by 1.29 per cent to 6.7641 in October 2016.
- HKEX’S USD/CNH futures set a record open interest level of 36,153 contracts (US\$3.6 billion notional) on 28 October 2016. HKEX has by far the highest open interest level among global exchanges, representing about two-thirds of the world’s total. The average daily volume also swelled to 1,699 contracts (US\$170 million notional) in October, its best level since the first quarter in 2016.
- HKEX’s Chief China Economist, Professor Ba Shusong, sees that reference to a basket of currencies in RMB fixing will contribute to the RMB’s position as a unique and international currency and facilitate the RMB’s internationalisation through emerging markets.
- In the Expert Corner, Society for Worldwide Interbank Financial Telecommunication (SWIFT)’s Head of Securities Markets & Standards, Asia Pacific, Mr Alexandre Kech, discusses the recent development of RMB bond market and its impact on SWIFT.

**RECAP ON HKEX’S LUNCHEON ON TOOLS TRACKING THE RMB’S GLOBALISATION**

The HKEX Fixed Income and Currency (FIC) Product Development Team sponsored an RMB-themed luncheon on 12 October 2016 that was supported by the Hong Kong Society of Financial Analysts (HKSFA). The main topic of the event was the growing importance of the RMB as an international currency and introduction of the TR/HKEX RMB Currency Indices (RXY). More than 120 people, including the representatives of Chinese and international banks, asset management companies, and securities firms with various backgrounds (research, fund management, financial products structuring, compliance, sales and marketing) attended the



**FROM THE CHIEF CHINA ECONOMIST’S VANTAGE POINT**

**Reference to a Basket of Currencies in RMB Fixing – Impacts and Policy Suggestions Expectation**  
**Professor Ba Shusong, Chief China Economist, HKEX**

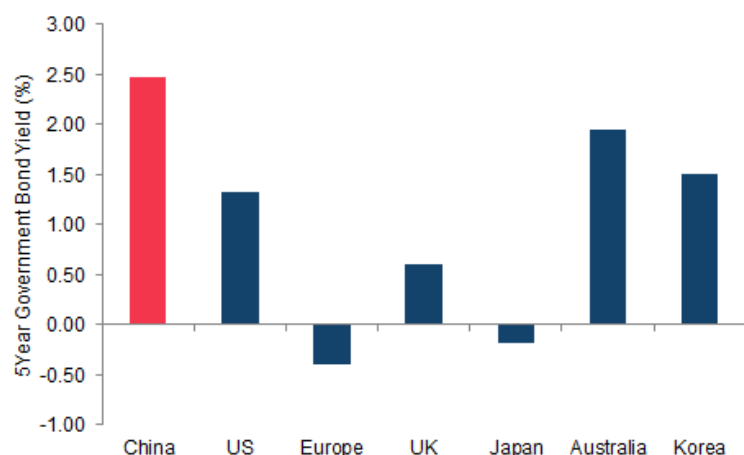
**1. Expectations of two-way movements in the RMB’s exchange rate will help the development of currency derivatives and a matured FX market that has depth and risk pricing capabilities**

The essence of shifting the main reference in RMB fixing from the US dollar to a basket of currencies is to sustain a perception of relative stability for the RMB against currencies of trade partners through offsetting appreciating currencies against depreciating currencies in the basket. This will also diminish the importance of the US dollar as a reference and weaken the range control on the USD/CNY rate, introduce an appropriate level of volatility and increase the cost of speculation on the USD/CNY exchange rate thereby forming an expectation of two-way movements in the RMB’s exchange rate.

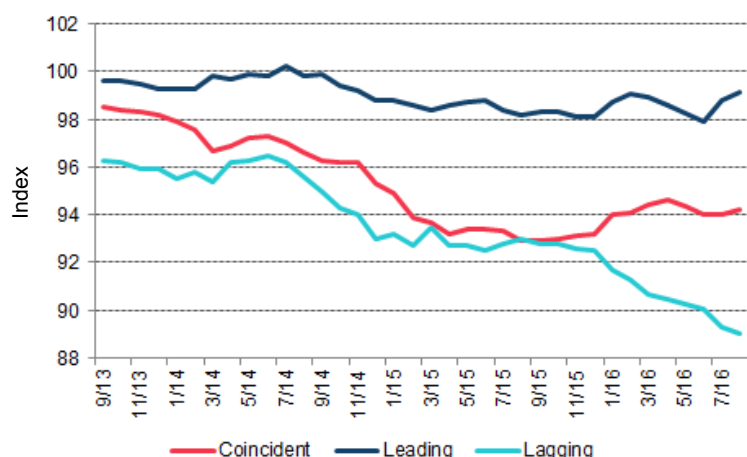
(to be continued on page 9)

## CHINA MACRO UPDATE

**Fig 1: Chart of the Month: Comparing China's Bond Yield to that of Other Countries**



**Fig 2: China's Macro-Economic Climate Index**



- The coincident index is the index reflecting the current basic trend of the economy, and it is calculated using the following data: (1) industrial production; (2) employment; (3) social demands (including investment, consumption and foreign trade); and (4) social incomes (including the government taxes, profits of enterprises and income of residents).
- The leading index is calculated using a group of leading indicators, which take a lead before the coincident index, and is used for forecasting the future economic trend.
- The lagging index is calculated using the lagging indicators, which lag behind the coincident index, and is mainly used for confirming the peak and trough of the economic cycle.

**TABLE 1**

China Key Economic Indicators	Current	Prior	Chg	Next Release Date
Real GDP (yoy %)	6.7	6.7	↔	17/01/2017
CPI (yoy %)	1.9	1.3	↑	09/11/2016
PPI (yoy %)	0.1	-0.8	↑	09/11/2016
Industrial Production (yoy %)	6.1	6.3	↓	14/11/2016
FAI (yoy %)	8.2	8.1	↑	14/11/2016
Foreign Investment (yoy %)	1.2	5.7	↓	08/11/2016
CFLP Manufacturing PMI	51.2	50.4	↑	01/11/2016
PBOC Bankers Confidence Index	46.5	43.7	↑	TBC
PBOC Bankers Loan Demand Index	55.7	56.7	↓	TBC
Share of Payments via SWIFT in CNY (%)	2.03	1.86	↑	24/11/2016
Exports (yoy %)	-10	-2.8	↓	08/11/2016
Imports (yoy %)	-1.9	1.5	↓	08/11/2016
M2 Money Supply (yoy %)	11.5	11.4	↑	10/11/2016
Retail Sales (yoy %)	10.7	10.6	↑	14/11/2016
Consumer Confidence Index	117.1	115.2	↑	30/11/2016
Regulated Reserve Ratio (%)	17.5	18.0	↓	Infrequent
Official Foreign Exchange Reserves (USD bn)	3166.4	3185.2	↓	07/11/2016
Three-Month SHIBOR (%)	2.83	2.79	↑	Continuous
10-Year Gov't Bond Yield (%)	2.74	2.82	↓	Continuous
USD/CNY Exchange Rate	6.77	6.66	↑	Continuous
TR/HKEX RXY Global CHH Index	94.97	94.70	↑	Continuous

## CHART OF THE MONTH

- Foreign investors in China's bond market have been drawn by its higher yield compared to other major economies. China's benchmark 5-year sovereign debt yields 2.50 per cent, compared favorably to 1.50 per cent in South Korea, 1.32 per cent in the US and even negative yields in Europe and Japan.

## REGULATORY/POLICY DEVELOPMENTS

- Chinese foreign exchange authorities have not rolled out new policy to terminate the annual USD50,000 forex purchase quota for individuals, and the regulator will keep the policy unchanged in future, said Wang Chunying, spokesperson for the State Administration of Foreign Exchange (SAFE) at a press conference on 21 October 2016.
- China's planned debt-to-equity swap programme will target at high-quality companies that face temporary difficulties, Lian Weiliang, a vice chairman of the National Development and Reform Commission (NDRC) said in a news briefing on 10 October 2016. He also added that the so-called "zombie firms" will be strictly forbidden from conducting debt-to-equity swaps, and the government will not force banks to conduct the swaps.
- China allowed 39 financial institutions, including three foreign banks, to issue large-denomination certificates of deposit (CDs) to individuals and companies starting from 20 October 2016. This brings the total number of institutions allowed to issue the large-denomination CDs to 353, according to a statement from the China Foreign Exchange Trade System (CFETS).

## MACRO ECONOMIC UPDATE

- China's economy showed signs of stabilisation as GDP growth remained at 6.7 per cent in the third quarter, despite challenges in balancing debt control and economic growth. Official figures released on 19 October 2016 kept China on track to meet the government's target of 6.5 to 7 per cent growth for the year, albeit being the slowest pace in a quarter of a century.

## MARKET/PRODUCT DEVELOPMENTS

- Effective 1 October 2016, the IMF included the RMB to the basket of currencies that make up the Special Drawing Rights, or SDR. Now, the RMB accounts for 10.92 per cent of the SDR basket, representing the third-largest share after the U.S. dollar's 41.73 per cent and the Euro's 30.93 per cent.
- SWIFT, a global provider of financial messaging services, has released its monthly compilation of data as part of its RMB tracker on 5 October 2016, with the latest figures showing an uptick in its share of RMB usage which surpassed 10 per cent – at present, over 57 countries have crossed this barrier by usage, while over the past two years this list had not passed 50 countries, illustrating the scope of the currency has increased in 2016.

## RMB FX MARKET DYNAMICS

### OFFSHORE USD/RMB

- In October 2016, USD/CNY fixings moved between 6.7008 and 6.7858, and CNH was trading 1.50 per cent lower versus the US dollar from a month ago.
- On 28 October 2016, the PBOC set the CNY fixing to 6.7858, a fresh six-year low. On the same day, the CNH rate also reached an all-time low of 6.7999 against US dollar, the weakest level since its introduction in 2010.
- The Hong Kong Monetary Authority (HKMA) announced on 27 October 2016 that it had designated two new banks as Primary Liquidity Providers (PLPs) for offshore RMB in Hong Kong, bringing the total to nine. These arrangements will “strengthen the liquidity and resilience of the offshore RMB market” and “enhance the infrastructure of the offshore RMB market in Hong Kong”, according to Norman Chan, Chief Executive of the HKMA.

Fig 3: Onshore/Offshore RMB Price Range

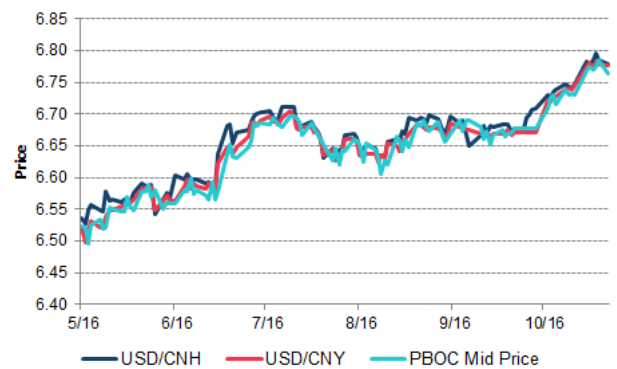


Fig 4: Implied Volatilities of OTC USD/CNH ATM Options

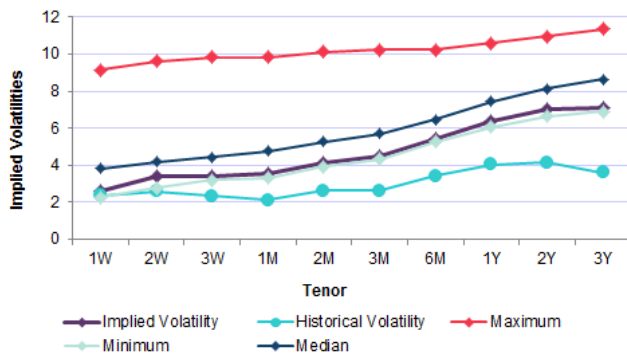
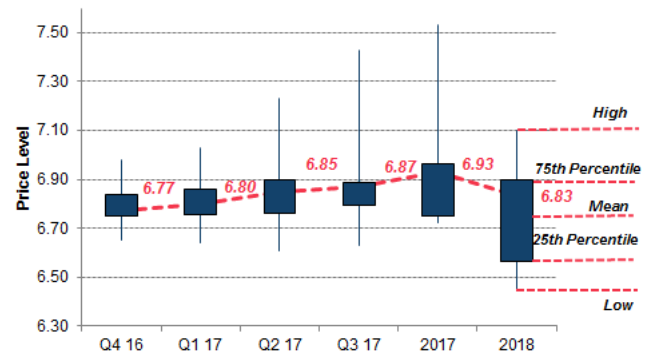


Fig 5: Market Forecasts for the Level of USD/CNH



## HKEX'S USD/CNH FUTURES

### PRODUCT HIGHLIGHTS

- Open interest (OI) was 36,153 contracts (US\$3.6 billion notional) on 28 October 2016, an all-time high, and an increase of more than 140 per cent year-on-year. HKEX has by far the highest open interest level among global exchanges, representing about two-thirds of world's total.
- The contract's average daily volume swelled to 1,699 contracts (US\$170 million notional) in October, its best level since the first quarter in 2016.
- The volume and open interest distribution is diversified at HKEX, reflecting a relatively balanced investor base. Trading volume was highest in the Dec-16, Mar-17, and Jun-17 contracts, which accounted for 62.3 per cent of total. Open interest concentrated in the Dec-16, Mar-17, and Jun-17 contracts, accounting for 67 per cent of total.

Fig 6: USD/CNH Futures Turnover and Open Interest

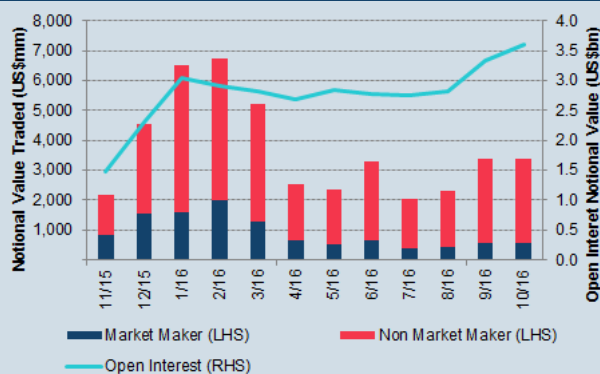


Fig 7: HKEX USD/CNH Futures Contract Provides Liquidity in Volatile Market

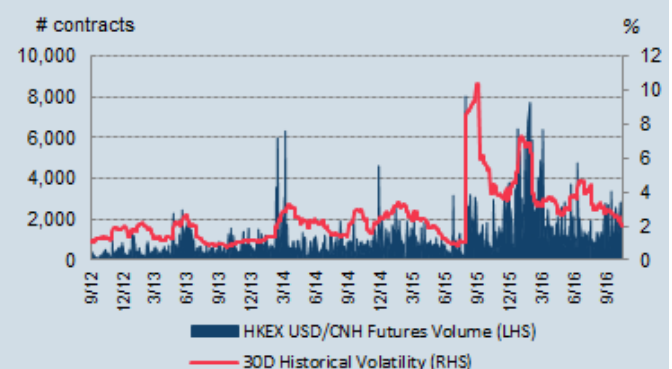


Fig 8: Breakdown of Volume by Contract Month (10/2016)

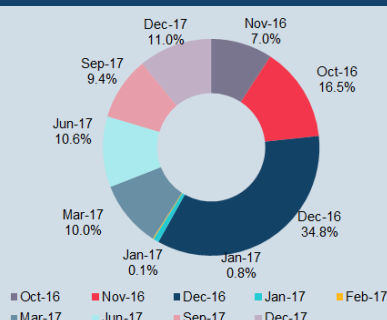
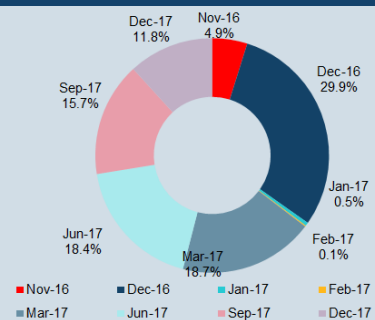


Fig 9: Breakdown of OI by Contract Month (31/10/2016)



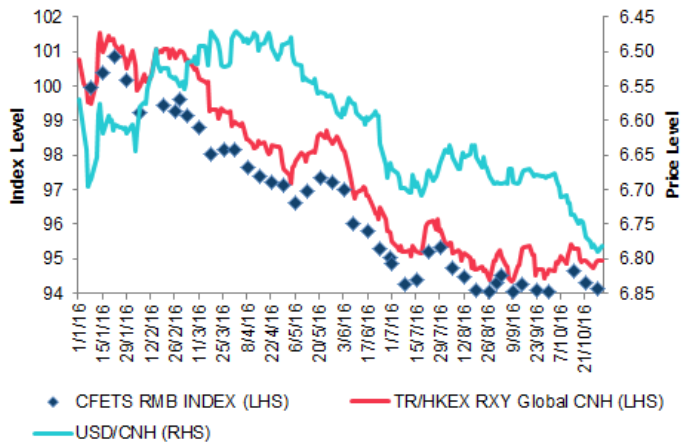
## TR/HKEX RMB CURRENCY INDICES (RXY)

- Compared with September 2016, TR/HKEX RXY Global CNH index fell by 0.28 per cent to 94.97 while the PBOC USD/CNY Fixing increased by 1.29 per cent to 6.7641 in October 2016.
- The largest contributor to the performance of the TR/HKEX RXY Global CNH Index in October 2016 was the USD, which appreciated 1.48 per cent against the CNH comparing with end of September 2016.

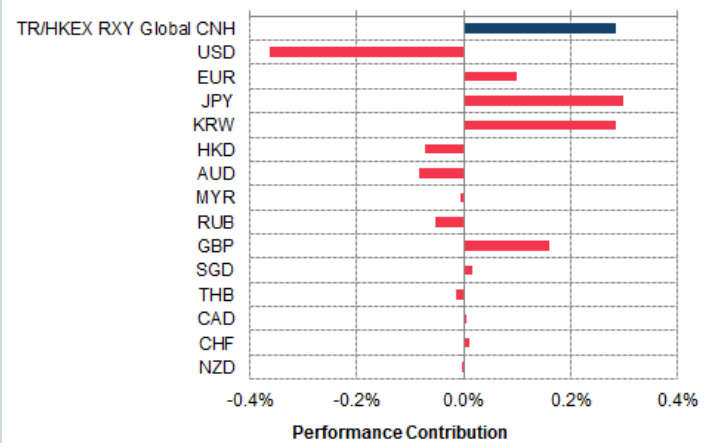
**TABLE 2: Summary Table for TR/HKEX RMB CURRENCY INDICES**

Indices	Return					Risk				
	2016/10/3 - 2016/10/31 (Month)	2016/9/1 - 2016/9/30 (Month)	Chg	MTD	YTD	30-Day Realized Volatility (as of 2016/10/31)	30-Day Realized Volatility (as of 2016/9/30)	Chg	Correlation with China Foreign Exchange Trade System (CFETS) RMB Index	Beta vs CFETS RMB Index
TR/HKEX RXY Global CNH	0.29%	-0.46%	↑	0.29%	-5.56%	2.37%	3.95%	↓	0.79	0.54
TR/HKEX RXY Global CNY	0.27%	-0.46%	↑	0.27%	-6.55%	3.45%	3.43%	↑	0.75	0.37
TR/HKEX RXY Reference CNH	0.00%	-0.38%	↑	0.00%	-5.58%	3.83%	3.90%	↓	0.70	0.46
TR/HKEX RXY Reference CNY	-0.01%	-0.38%	↑	-0.01%	-6.57%	1.93%	3.57%	↓	0.83	0.46

**Fig 10: Performance: TR/HKEX RXY Global CNH, CFETS RMB Index and USD/CNH**



**Fig 11: Monthly Performance Contribution Breakdown: TR/HKEX RXY Global CNH (October 2016)**



## PRODUCT HIGHLIGHTS

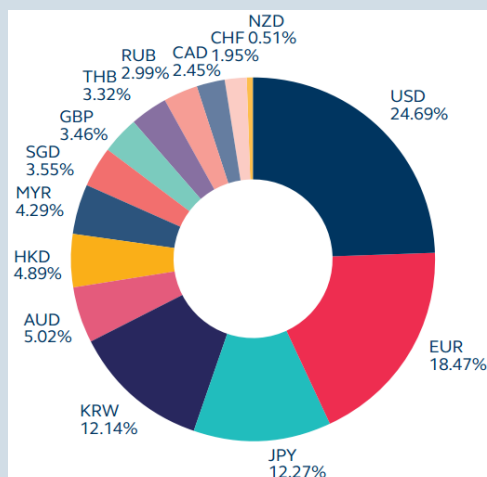
- The RXY indices offer independent, transparent and timely benchmarks for RMB against Mainland China's most important trade partners' currencies.
- The indices are calculated based on WM/Reuters foreign exchange rates (WM/Reuters FX Rates) and managed in accordance with the IOSCO (International Organisation of Securities Commissions) principles for financial benchmarks.
- The RXY indices are designed to be the basis for investment and trading products such as futures, options and exchange traded funds.

## METHODOLOGY

- Calculation Method:** Geometric Average
- Weighting Method:** Bilateral trade weighted with adjustment for Hong Kong re-exports
- Trade Data Source:** UN Comtrade, Hong Kong Census and Statistics Department
- Weighting Rebalance:** Annual review. Announcement in June, Implementation on the first business day of Q4
- Calculation Frequency:** Hourly
- FX Rate Data Source:** WM/Reuters FX Rates
- Base Date:** 100 as of 31 December 2014

**Fig 12: TR/HKEX RXY Global CNH Currency Index**

Index Weights: Valid Until 29 September 2017



For more details, a complete methodology document is available at: [financial.thomsonreuters.com/fxindices](http://financial.thomsonreuters.com/fxindices)

**TABLE 3: Index Weights**

Currency	RXY Global Currency Indices	RXY Reference Currency Indices	CFETS RMB Index
USD	24.69%	28.09%	26.40%
EUR	18.47%	21.03%	21.39%
JPY	12.27%	13.97%	14.68%
KRW	12.14%	0.00%	0.00%
AUD	5.02%	5.72%	6.27%
HKD	4.89%	5.56%	6.55%
MYR	4.29%	4.88%	4.67%
SGD	3.55%	4.04%	3.82%
GBP	3.46%	3.93%	3.86%
THB	3.32%	3.78%	3.33%
RUB	2.99%	3.41%	4.36%
CAD	2.45%	2.79%	2.53%
CHF	1.95%	2.22%	1.51%
NZD	0.51%	0.58%	0.65%



## OFFSHORE RMB AGAINST OTHER CURRENCIES

### EUR/CNH

- The CNH was trading 0.81 per cent higher against the EUR in October 2016 from a month ago, and remained in a relatively tight range of 7.37 to 7.51.
- The implied volatility of 3M OTC options fluctuated around 8 per cent in October 2016. It might be related to the fact the European Central Bank (ECB)'s decision in extension of its asset-purchase program at the 8 December 2016 policy meeting.
- On the FX radar, the valuation, fundamental, and carry factors were well above their historical average, while the risk and sentiment factors were below their historical average.

Monthly CNH Performance vs EUR

↑ 0.81%

Implied Volatility

7.8%

Fig 13: FX Radar\*

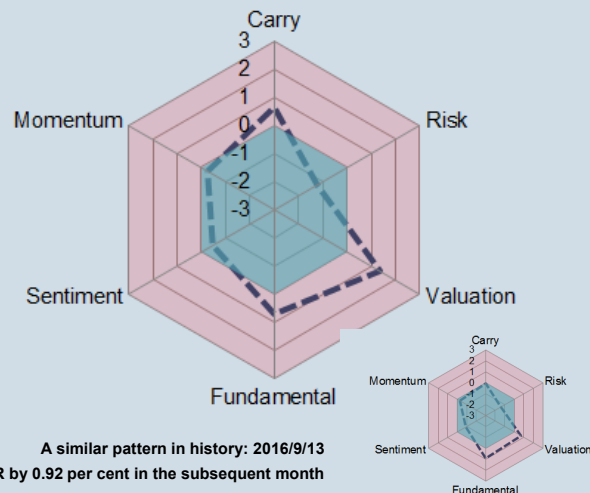


Fig 14: FX Volatility (3M Implied)

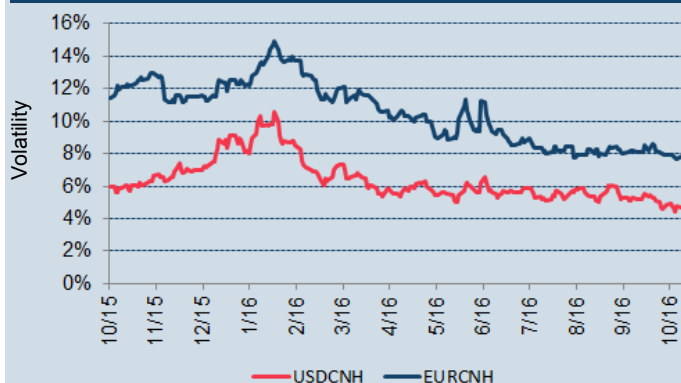
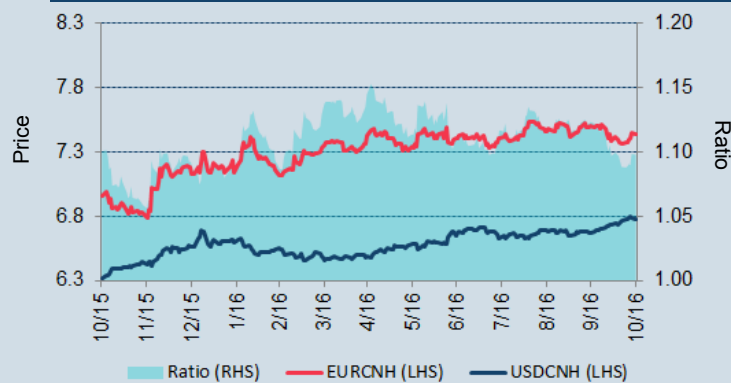


Fig 15: Price Ratio: EURCNH / USDCNH



### AUD/CNH

- The CNH was trading 0.81 per cent lower against the Australian dollar (AUD) in October 2016 from a month ago, as a pickup in Australia's Consumer Price Index (CPI) accompanied by stickiness in the core rate inflation may bolster the near-term outlook for AUD/CNH due to a dampened market speculation for additional monetary support.
- The implied volatility rebounded to near 10 per cent in October 2016.
- On the FX radar, the risk and sentiment factors were below their historical average, while the valuation and fundamental factors were above their historical average.

Monthly CNH Performance vs AUD

↓ -0.81%

Implied Volatility

9.6%

Fig 16: FX Radar\*

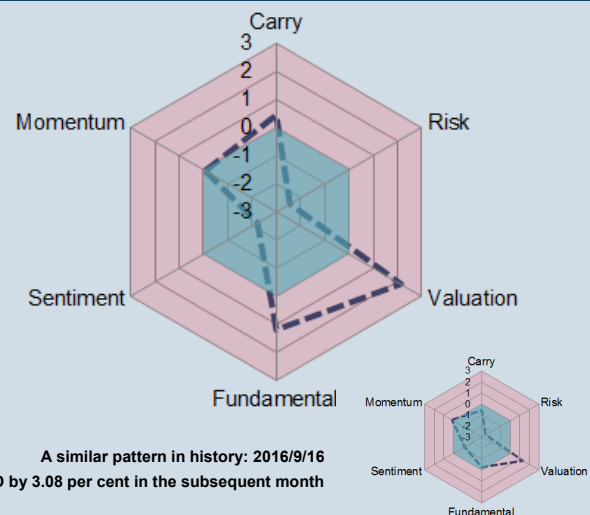


Fig 17: FX Volatility (3M Implied)

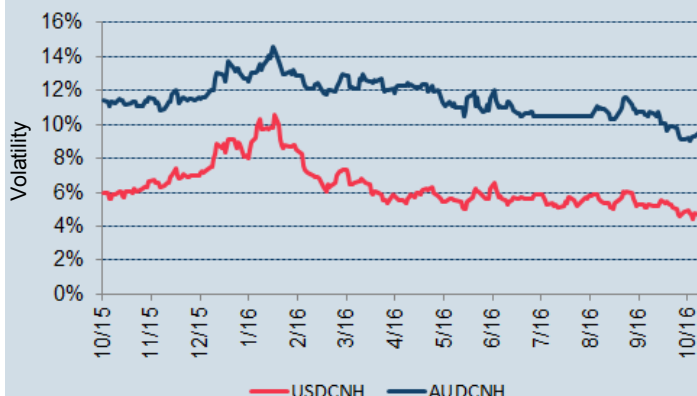
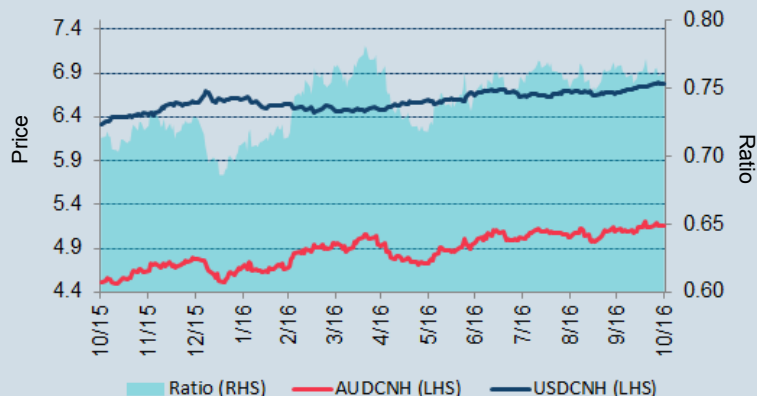


Fig 18: Price Ratio: AUDCNH / USDCNH



**JPY/CNH**

- The CNH was trading 1.84 per cent higher against the JPY in October 2016 from a month ago, as the Bank of Japan may carry its wait-and-see approach into 2017 as its officials continue to assess the impact of the quantitative/qualitative-easing (QQE) program with 'yield-curve control'.
- The 3-month implied volatility OTC options rebounded to near 11 per cent in October 2016.
- On the FX radar, the risk, carry, sentiment, and fundamental factors were above their historical average, while the valuation and momentum factors were below their historical average.

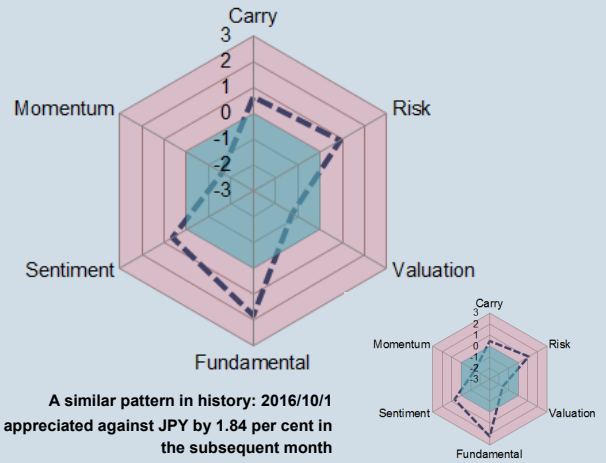
**Monthly CNH Performance vs JPY**

↑ 1.84%

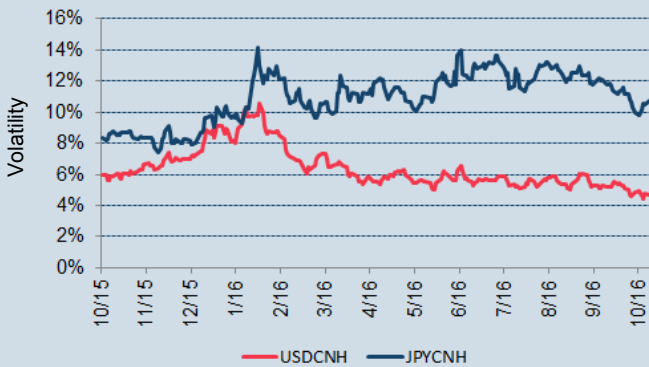
**Implied Volatility**

10.8%

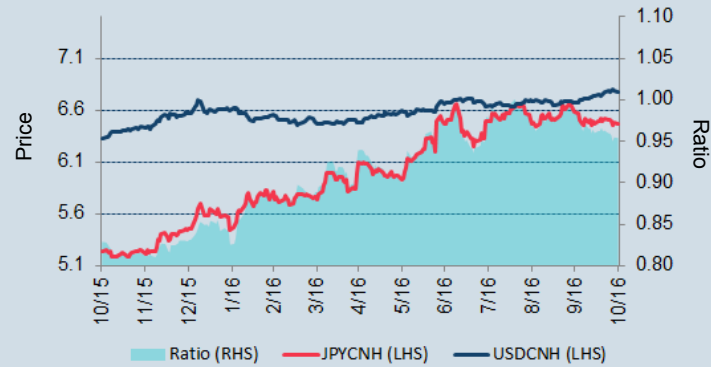
**Fig 19: FX Radar\***



**Fig 20: FX Volatility (3M Implied)**



**Fig 21: Price Ratio: JPYCNH / USDCNH**



**TABLE 4: Summary Table for RMB Currency Pairs**

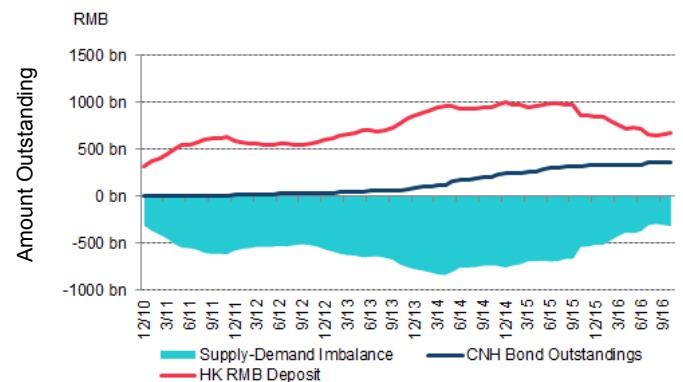
	Performance					Volatility					
	Oct	Sep	Chg	Prior 3 Month	YTD	Implied	Prior	Chg	Historical	Prior	Chg
USDCNH	-1.51%	0.22%	↓	-2.22%	-3.20%	4.7%	5.3%	↓	3.1%	3.4%	↓
EURCNH	0.81%	-0.50%	↑	-0.48%	-3.64%	7.8%	8.2%	↓	5.9%	6.1%	↓
AUDCNH	-0.81%	-1.71%	↑	-2.49%	-7.77%	9.6%	10.5%	↓	8.9%	9.1%	↓
JPYCNH	1.84%	-1.81%	↑	0.45%	-18.67%	10.8%	12.1%	↓	13.4%	13.5%	↓

**OFFSHORE BOND MARKET DYNAMICS**

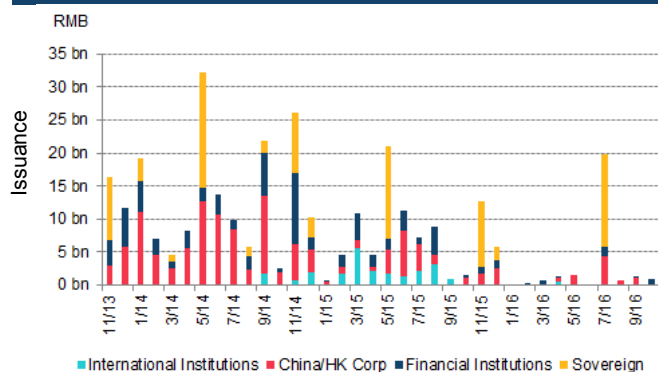
**OFFSHORE RMB BOND MARKET COMMENTS**

- RMB deposits in Hong Kong rebounded by 1.9 per cent month-on-month to RMB665.5 billion in September 2016. The total remittances of RMB for cross-border trade settlement amounted to RMB382.9 billion in September 2016, compared to RMB398.8 billion in August 2016.
- Industrial and Commercial Bank of China's Tokyo branch sold a RMB500 million (USD73.8 million) Dim Sum bond on 25 October 2016, the first offshore RMB Pro-Bond to be sold in Japan. Japan's Pro-Bond market, limited to professional investors and certain foreign investors, is designed to encourage foreign issuers by allowing their registration for existing debt programs and removing requirements of listing document translation into Japanese.

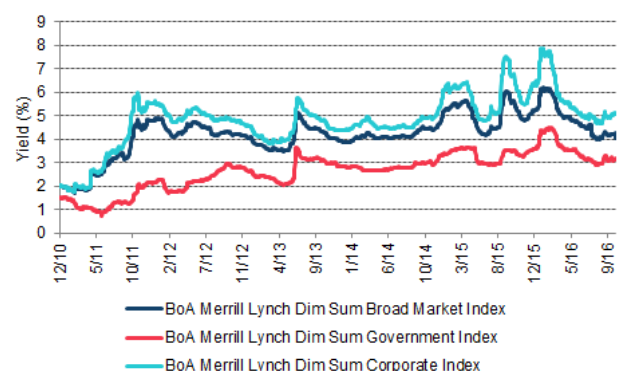
**Fig 22: Offshore RMB Deposits vs Dim Sum Bonds**



**Fig 23: Offshore RMB Bond Issuances by Issuer Type**



**Fig 24: Dim Sum Bond Performance**



Sources: Bloomberg, WIND (31 October 2016)

Past performance is not a guide to the future  
\* For detailed information, please see appendix

For more information, please email FICD@hkex.com.hk

## ONSHORE RMB BOND MARKET COMMENTS

### ONSHORE BOND MARKET DYNAMICS

- Onshore bond issuance increased 16.5 per cent to RMB 2.6 trillion in October 2016 from RMB 2.3 trillion in October 2015. Certificates of deposit (CDs) issuance in October 2016 was up 41 per cent from a year ago.
- As of 18 October 2016, local governments have sold nearly 2,000 local government bonds worth RMB9.20 trillion in 2015 and 2016; 80 per cent of which were issued through a debt-to-bond program that allows local government to refinance and pay back the old debt. In addition, local governments have raised RMB3.66 trillion in sales of over 3,700 city investment bonds.

Fig 25: MoF T-Bonds Yield 5Y: Onshore vs Offshore (%)

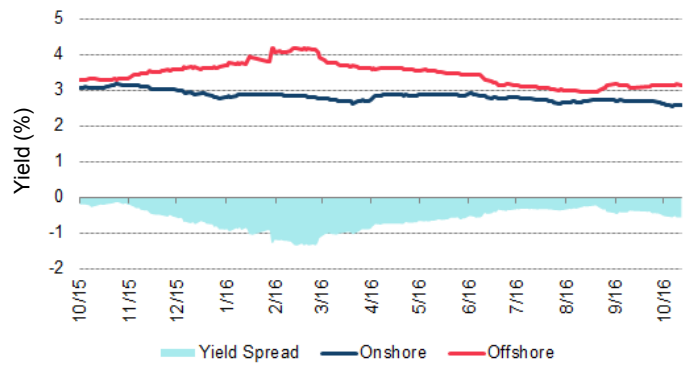


TABLE 5

Key Figures on Interbank Market Cash Bond Transactions (classified as per bond types, for October 2016)

Bond Type	Number of Deals	Trading Value(RMB 100M)	Yield to Maturity(%)
Policy Financial Bond	47,245	41,375.80	2.8389
Treasury Bond	11,611	8,897.14	2.5474
Medium-term Note	10,575	7,075.43	4.5831
Corporate Bond	7,426	4,137.58	4.2393
CDs	8,849	21,999.58	2.9987
Commercial Paper	11,660	8,681.32	3.2192
Central Bank Paper	1	2.58	2.1398
Others	3,876	5,429.56	3.7384
<b>Total</b>	<b>101,243</b>	<b>97,598.99</b>	<b>3.1042</b>

Fig 26: MoF T-Bond Outstanding Split by Tenor

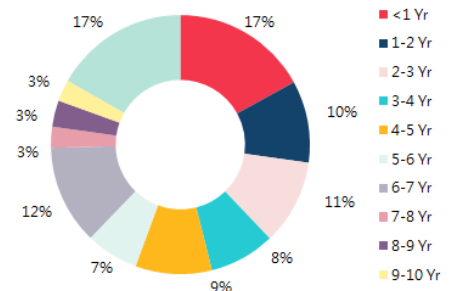


TABLE 6

NAFMII Guidance for Non Fixed Income Debt Issuing (as of 2016/10/31)

	1Yr	MoM	3Yr	MoM	5Yr	MoM	7Yr	MoM	10Yr	MoM	15Yr	MoM	20Yr	MoM	30Yr	MoM
AAA+	2.92	↑	3.39	↓	3.57	↓	3.96	↓	4.21	↓	4.85	↓	5.04	↓	5.29	↓
AAA	3.12	↑	3.47	↓	3.76	↓	4.26	↓	4.50	↓	5.15	↓	5.50	↑	5.80	↑
AA+	3.33	↑	3.85	↓	4.18	↓	4.75	↓	5.15	↓	5.79	↓	6.20	↑	6.53	↓
AA	3.77	↑	4.33	↓	4.66	↓	5.42	↓	5.66	↓	6.55	↑	6.90	↓	7.37	↓
AA-	5.06	↓	5.68	↓	6.05	↓	7.16	↓	7.56	↓	8.20	↓	8.60	↓	8.90	↓

NAFMII – National Association of Financial Market Institutional Investors

Fig 27: Foreign Participation in the CIBM Market

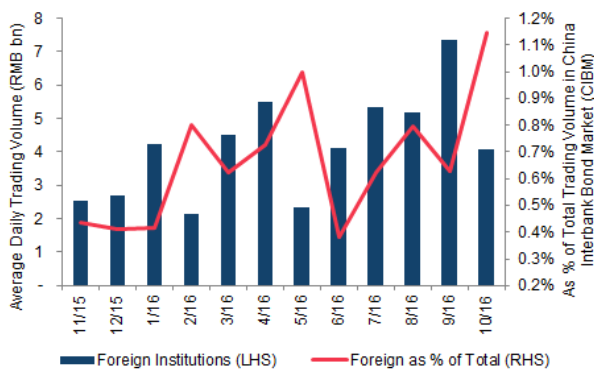


Fig 28: Onshore Bond Holdings by Foreign Institutions

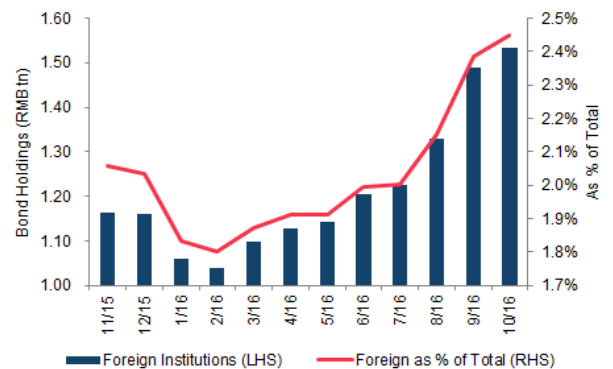


Fig 29: Bond Holdings Composition by Foreign Institutions

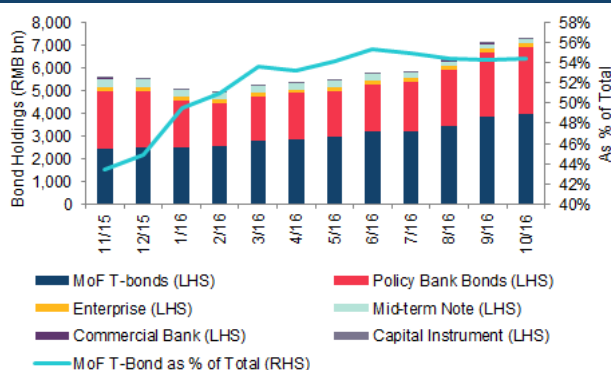
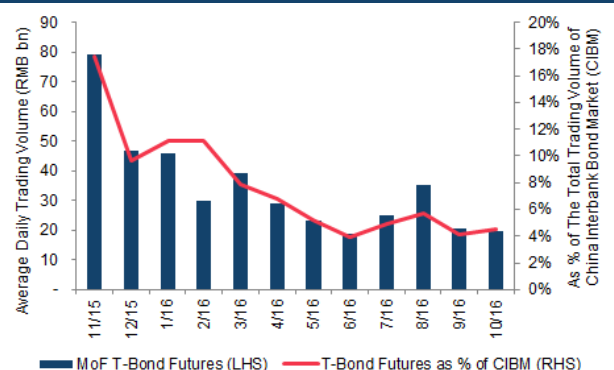


Fig 30: MoF T-Bond Futures Trading Volumes



## ONSHORE/OFFSHORE SHORT-TERM INTEREST RATE DYNAMICS

### ONSHORE/OFFSHORE RMB STIR MARKET COMMENTS

- China's overnight money rate climbed to the highest level in 18 months on 25 October 2016, fueled by capital outflows as the RMB weakened to a six-year low. The one-day repurchase rate, a gauge of interbank funding availability, jumped by 17 basis points, the biggest change since February, to 2.41 per cent, which is the highest level since April 2015. The rates rose after the People's Bank of China weakened its daily reference rate for the RMB for the third day in a row.
- The yield on Chinese 10-year government bonds dropped to record lows in recent weeks due to concern about the economy and lack of other investment opportunities, as bond yields drop with rising prices. Meanwhile, short-term rates have held steady or risen, as the Chinese authorities have tried to make it harder for speculators to borrow money for short periods to fund their investments.

Fig 31: CNH Implied Yield vs. USD/CNH

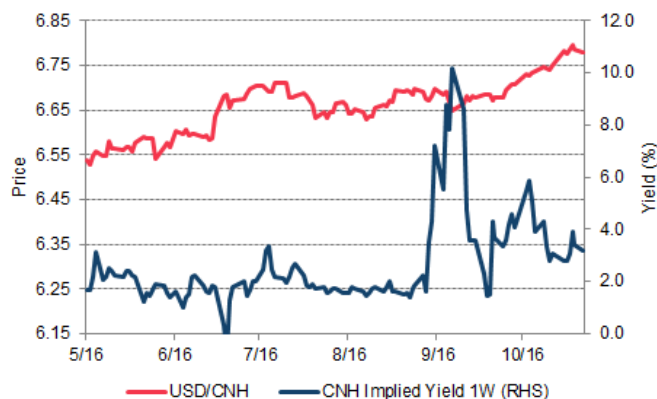


Fig 32: CNY SHIBOR Yield Curves

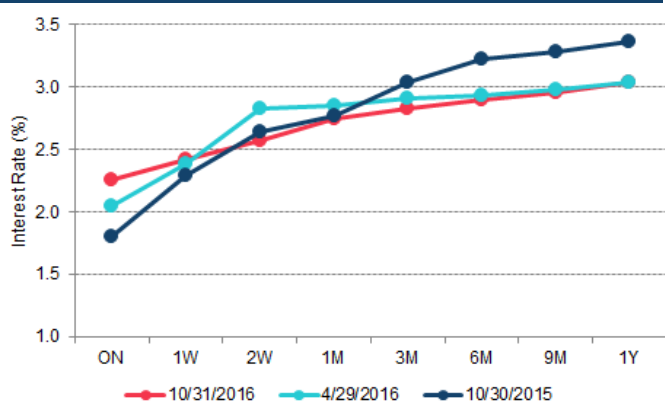


Fig 33: CNH HIBOR Yield Curves

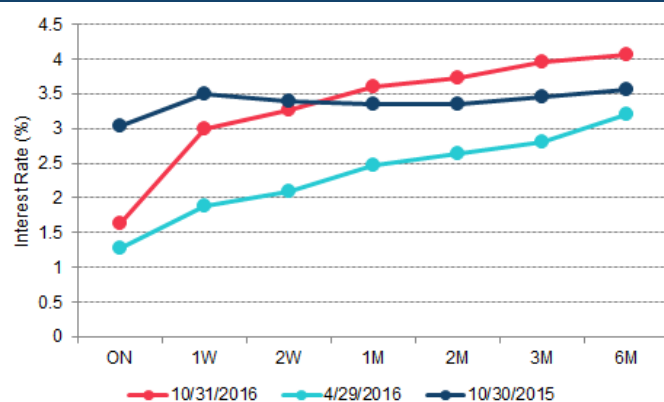


Fig 34: Onshore IRS (7D Repo) Yield Curves

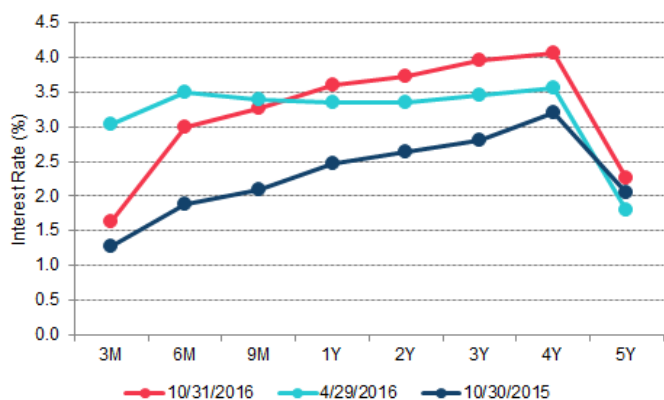


Fig 35: Onshore IRS Trading Notional Principal

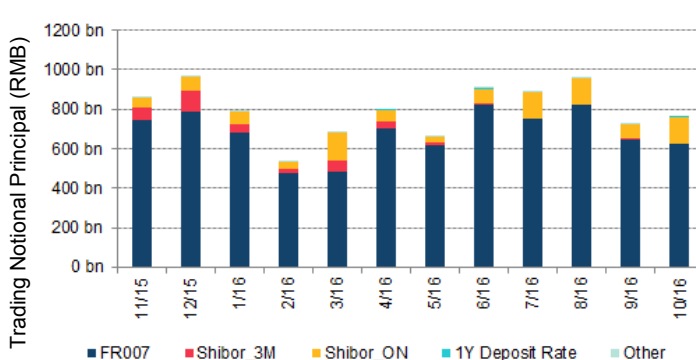


Fig 36: CNY SHIBOR vs CNH HIBOR

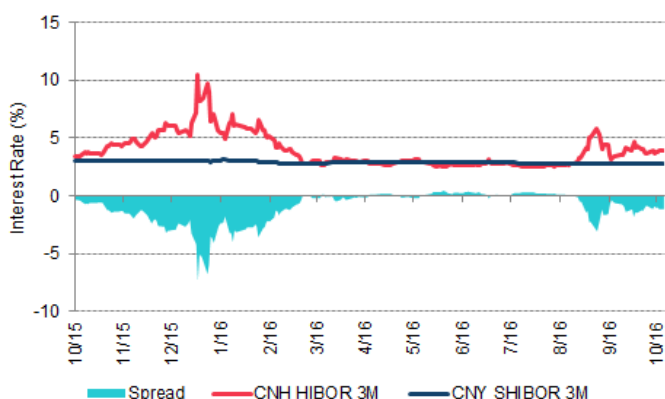
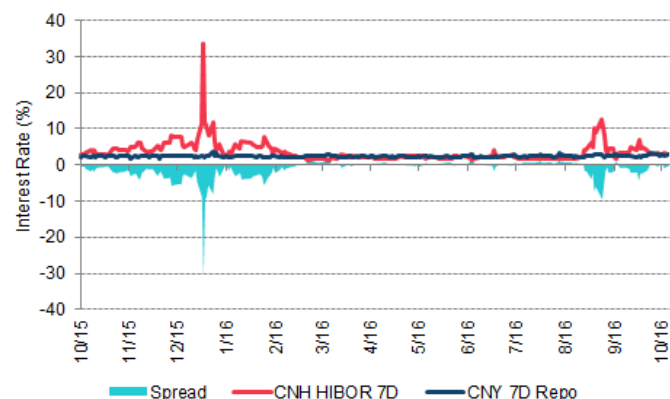


Fig 37: CNY 7D Repo vs CNH HIBOR





(Continued from page 1)

The market needs to adapt to greater volatility in the RMB's exchange rates. Expectations of two-way movements in the currency help the residents and enterprises increase their FX risk awareness, and contribute to the development of a forward market and FX risk hedging instruments. RMB indices that refer to a basket of currencies are possible underlyings of RMB derivative products as FX risk management tools. A highly efficient monetary derivative market and market participants with matured sense of FX risk management are the necessary financial environments to be developed for the introduction of a floating rate FX system.

## 2. Conform to the trend of capital market opening and facilitate the RMB's internationalisation

### 2.1. The shift of referring to a basket of currencies helps the internationalisation of trade channels of the RMB

In the historical development of the RMB's internationalisation, it is the critical stage at present. The inclusion of the RMB in the SDR basket has the symbolic significance in that it increases international attention on the RMB and international understanding of the currency.

**Table 7: Under the new method, the RMB's weighting is lower than expected with contribution to financial indicators accounting for merely 0.8% (as of 30 November 2015)**

Currency	Trade weighting	Contribution to trade (A)	Financial indicators	Contribution to financial indicators (B)	Weighting of each currency (w=A+B)	Weighting in 2010
USD		13.00%		28.70%	41.70%	41.90%
Euro		17.40%		13.50%	30.90%	37.40%
GBP	50%	4.70%	50%	3.40%	8.10%	11.30%
JPY		4.80%		3.50%	8.30%	9.40%
RMB		10.10%		0.80%	10.90%	

### 2.2. The shift of referring to a basket of currencies makes the RMB a relatively stable currency compared to those of major emerging economies

In the development history of international financial market, the currency of a country which is on the path of internationalisation is usually first widely accepted by peripheral countries and regions with close economic and financial ties with the country. In the case of the RMB, with the implementation of the Belt and Road strategy and closer cooperation in international industrial capacity between China and its peripheral economies, an increasing number of Chinese enterprises have been going out of the country to compete internationally, and they need the RMB to become more international to provide the financial supports. This has created critical demand for the RMB to become a regional currency among economies related to the Belt and Road. It has also exerted demand on the RMB's exchange rates to remain stable against emerging economies and other major trade partners. In the foreseeable future, the RMB's internationalisation will be reflected more in the RMB complementing or even replacing international currencies dominant in emerging and peripheral countries, instead of trying to expand its market share simultaneously globally.

### 2.3. The RMB's internationalization is slowing in the short term, which challenges the FX mechanism

Judging by the size of the offshore RMB market, the RMB's internationalisation has slowed recently. The currency's internationalisation requires support from the opening of the capital market and a relatively stable exchange rate. Under the "impossible trinity" and constraints in the international and domestic financial environments, the shift of reference in RMB fixing to a basket of currencies is the best way forward. It ensures that the RMB's exchange rate against a basket of currencies will be stable, and demands imposed by the currency's internationalisation and the orderly opening of the capital market on the RMB's exchange rate will be met. It can be said that free flow of capital and a floating exchange rate has been partially achieved.

## 3. More flexible two-way RMB exchange rate movements and the new mode of asymmetric devaluation

### 3.1. More flexible two-way RMB exchange rate movements

The RMB has all along been a managed currency in the course of its marketisation. The tools of management are mainly daily limits on price range and the mid-price. In the past, flexible widening of the range in which the RMB's exchange rate may fluctuate was reflected in the widening of the daily limits on price movement. The USD/CNY rate in the interbank FX spot market may fluctuate within the prescribed range according to the USD/CNY mid-price announced by CFETS on the day, or the daily limits on price movement. In the beginning, the daily limits were set at  $\pm 0.3$  per cent, then was expanded to 0.5 per cent on 18 May 2007, 1 per cent on 16 April 2012 and 2 per cent on 15 March 2014. Till then the need for the daily fluctuation of RMB has basically been satisfied.

By shifting its reference to a basket of currencies, the RMB's exchange rate becomes more flexible against the US dollar and there is more frequent fluctuation. This facilitates the transition to a more flexible exchange rate regime. If widening of the trading band is adopted, during times of great pressure on the currency to appreciate or depreciate, it is likely the exchange rate will immediately hit the upper or lower limit. In contrast, if the mid-price and the trading band are determined with reference to a basket of currencies, provided the currency direct movements within the basket do not because a deviation of the basket's value from the trading band, the trading band is not considered to have been breached. Certainly this requires the central bank to have a higher degree of transparency and credibility. For example, the central bank has to announce the weightings of the basket of currencies. At present, expectations for exchange rate movements have basically stabilised.

### 3.2. A new mode of asymmetric devaluation in early 2016

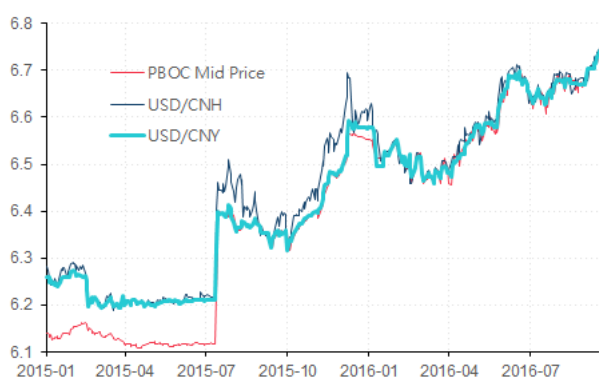
In early 2016, when the US dollar depreciated significantly against other major currencies, Adherence to referring to CFETS' basket of currencies in RMB fixing will lead to a significant rise in the CNY/ USD rate. At a time when the Chinese economy is still at risk of declining, the central bank of China did not wish to see significant appreciation in its currency. When the US dollar is strengthening, reference to CFETS' basket of currencies implies RMB will significantly depreciate against the US dollar. Such depreciation will help rectify previous overvaluation of the CNY/ USD rate. For the time being, China's central bank may continue to adopt this new mode of asymmetric devaluation which follows two patterns: (1) when the US dollar index is strong, the RMB will refer more to the CFETS basket to facilitate depreciation against the US dollar while remaining stable or even rising in value against the basket of currencies; (2) when the US dollar index is weak, the RMB will refer more to the US dollar and weaken along with the US dollar allowing the RMB to depreciate against the CFETS basket of currencies.

### 4. Policy suggestions

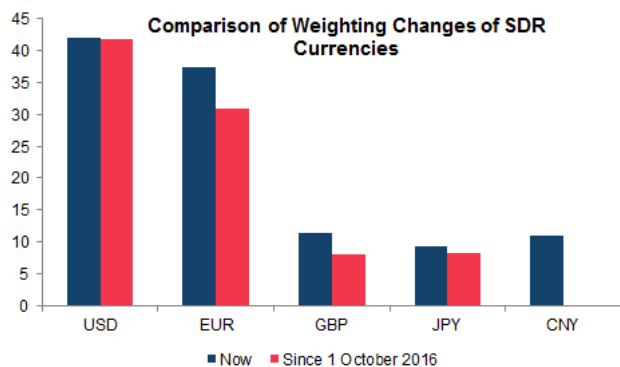
The mid-price mechanism strikes a balance between efficiency and stability. It is a crucial intermediary stage on the path towards a floating rate regime. China must objectively evaluate its handling of exchange rate movements, prepare for more substantial currency fluctuation and stay committed to the goal of eventually opening up its capital account. Reference to a basket of currencies in RMB fixing will contribute to the RMB's position as a unique and international currency and facilitate the RMB's internationalisation through emerging markets.

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**Fig 38: PBOC Mid Price and Previous Day's Closing Price of USD/CNY and USD/CNH**



**Fig 39: A Comparison of Weighting Changes of SDR Currencies and How SDR Weightings Are Determined**



**How SDR Weightings are Determined?**



## EXPERT CORNER

### RMB BOND MARKET RECENT DEVELOPMENT AND IMPACT ON SWIFT

Contributed by Alexandre Kech, Head of Securities Markets & Standards, Asia Pacific, SWIFT

With the recent announcement of the Chinese interbank bond market opening up to overseas investors, the expectation is certainly high for overseas investors who have yet to be involved in this market. Especially for those yield seeking investors for whom the bond yields of almost two-third of overseas government debt are lower than 2 per cent, the Chinese interbank bond market present itself as a better investment option.

The bond market in China is now the third largest in the world after the US and Japan according to an Institute of International Finance (IIF) study, and is valued at USD 7.4 trillion, according to the Financial Times only 2 per cent is held by institutional investors. The room for overseas institutional investors' involvement is expected to grow.

#### Onshore Market Development

In mid-2012, the investment guideline of Qualified Foreign Institutional Investor (QFII) has been updated by CSRC to allow QFII to invest into the inter-bank bond market. Subsequently, in early 2013, Renminbi Qualified Foreign Institutional Investors Pilot Programme (RQFII) investment proportion has been removed for fixed income and equities. Both regulation changes have positively impacted investment into the onshore bond market denominated in CNY. Since then, the settlement amount of the onshore RMB bond has increased steadily as shown by SWIFT watch data. The onshore bond settlement amount even surpassed the offshore bond amount in Q4 2014 and is almost 6 times the amount of offshore bond settlement in Jul 2016.

However, only 68 institutions use SWIFT for onshore Bond settlement settled in CNY, compared to 387 institutions for offshore Bond settlement in CNH. These data reflect the restrictions of QFII and RQFII programmes where only qualified institutions are permitted to enter the Chinese market. With the China Inter-Bank Bond Market opening up to overseas institutional investors, the number of SWIFT members using onshore RMB Bond settlement (CNY) instructions is expected to grow as a consequence of the growing overseas participation. These SWIFT based instructions will also improve the STP rate of bond settlement.

#### Offshore Market Development

The offshore market, on the other hand, shows a steady decline in terms of total settlement amount and this is no surprise. As SWIFT Watch data shows, the offshore bond settlement amount shows a cooling down of the offshore bond market. This is consistent with the offshore bond issuance trend where debt issuers look to issue bonds onshore due to lower funding costs and relaxed regulations in China.

Renminbi (RMB)-denominated bonds issued and settled outside the People's Republic of China (PRC) are known as offshore bonds. They are freely accessible to international investors and are settled in offshore RMB, sometimes referred to as CNH, the currency to trade and settle in Hong Kong.

The use of offshore CNY creates a well-known industry issue around settlement of offshore RMB, as no ISO currency code represents "CNH". The SWIFT network would reject MT instructions where "CNH" is used in the ISO currency field. This led to the formation of the Offshore RMB Market Practice Group to facilitate the discussion on a possible workaround.

Details can be found in the Offshore CNY best practice guide here:

<https://www.swift.com/standards/standards-resources?category=7056>

For those SWIFT members that need to indicate CNH as the settlement currency of offshore RMB bonds, they are required to process an optional attribute in the settlement instructions, using Hong Kong as the "Place of Settlement" to indicate that the currency used is CNH even though CNY is indicated in the ISO currency field of the instruction.

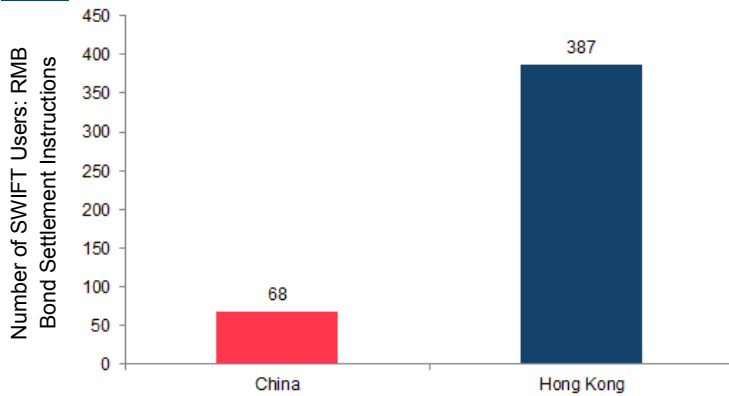
In the future, this issue will need to be addressed further as it hinders the adoption of ISO 20022 to support offshore RMB related transactions. A recent example would be the China Hong Kong Mutual Funds Recognition programme, that allows both territories to cross distribute their locally domiciled funds into each other's market. There is an industry demand to implement the usage of ISO 20022 instructions for cross-border subscriptions and redemptions instructions. However without CNH as a valid ISO currency code, there is a need for the market practitioners (i.e. distributors, transfer agencies and service vendors) to agree upon a market practice in order to address this operational challenge.

#### Cross-Connect

To further stimulate cross-border capital flows, HKEX stated that it will explore the creation of a "Bond Connect" scheme to provide cross-border cash bond trading and settlement connectivity with China. This is an excellent opportunity to harmonise the instruction format with an industry protocol that has been widely adopted for cross-border settlement.

**Disclaimer:** This content is for general information purposes only and should not be used as a substitute for consultation with professional advisors.

Fig 40: SWIFT Users: RMB Bond Settlement Instructions



Alexandre Kech is Head of Securities Markets & Standards, APAC at SWIFT.

As Head of Securities Markets, APAC, Alexandre is responsible for rolling out SWIFT's strategy and product offering in the Asia-Pacific region for the securities customer segment. He is also looking at FinTech engagement in the region with a particular focus on Distributed Ledger Technology for securities.

Securities represent 50% of SWIFT's messaging volumes with a double digits annual growth. We deliver products and services to more than 80 securities market infrastructures (Exchange, CCP, CSD), and thousands of asset managers, brokers and custodians, enabling them to transact in a secure, resilient, reliable, standardized, automated and, therefore, cost-efficient way.

As Head of Standards, APAC, Alexandre is also managing a dream team of standards experts in Singapore, Sydney, Hong Kong, Beijing and Tokyo who engage the APAC community in International Standards and Market Practices discussions, enable ISO standards implementation and lead market practice harmonisation and standards adoption in the APAC region.

## APPENDIX: DEFINITION OF THE FX RADAR

We selected a number of factors that drive RMB currency pairs, including carry (yield spread), risk (volatility), valuation (terms of trade), fundamentals (trade balance), sentiment (risk reversal), and momentum (three-month return). Factor values were normalized based on the most recent one-year data and plotted on our FX radar graph. For example, a factor value of 1 for “carry” indicates that the current yield spread is one standard deviation above its mean over the past year.

The black dotted line represents the prevailing factor dynamics of the specific RMB FX pair. Against the current factor dynamics, we identified the most similar patterns in past history by means of optimization across the six driving factors. The historical price movement of that particular period is shown for reference.

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