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RESEARCH REPORT

THE NEW LANDSCAPE OF MAINLAND CHINA'S BALANCE OF PAYMENTS AND HONG KONG'S NEW POSITIONING AS A FINANCIAL CENTRE

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SUMMARY

The apparent drop in current account surplus is one of the changes on the current economic and financial fronts in Mainland China that have far-reaching impacts. In 2018, the Mainland's current account surplus fell by 70% year-on-year to US$49.1 billion, bringing its percentage contribution to the gross domestic products (GDP) to 1.55%. This trend continued in the first three quarters of 2019. The gradual shrinking of the Mainland's current account surpluses in its international balance of payments (BoP) essentially reflects that the engine of the Mainland's economic growth is shifting from external demands to a combination of domestic and external demands. Large surpluses in the current account would become history, and the share of the current account surplus in GDP would probably fluctuate within range of 1%, possibly with slight dips into the negative territory occasionally.

The BoP cycle of the Mainland has basically ventured into a stage marked by a small current account surplus or even a deficit, implying that capital inflows under the capital account are required to support its BoP. This in turn means that the Mainland financial market needs to be further opened up. Apart from this, from a strategic perspective, the further opening-up of the Mainland financial market and its closer ties with the world can provide certain buffer against the anti-globalisation movement. Therefore, at the current stage, one of the priorities in Mainland China's financial market reform and opening-up should be how to better connect with the international market and to attract international capital inflows, and to remove obstacles for overseas investors to access the Mainland market.

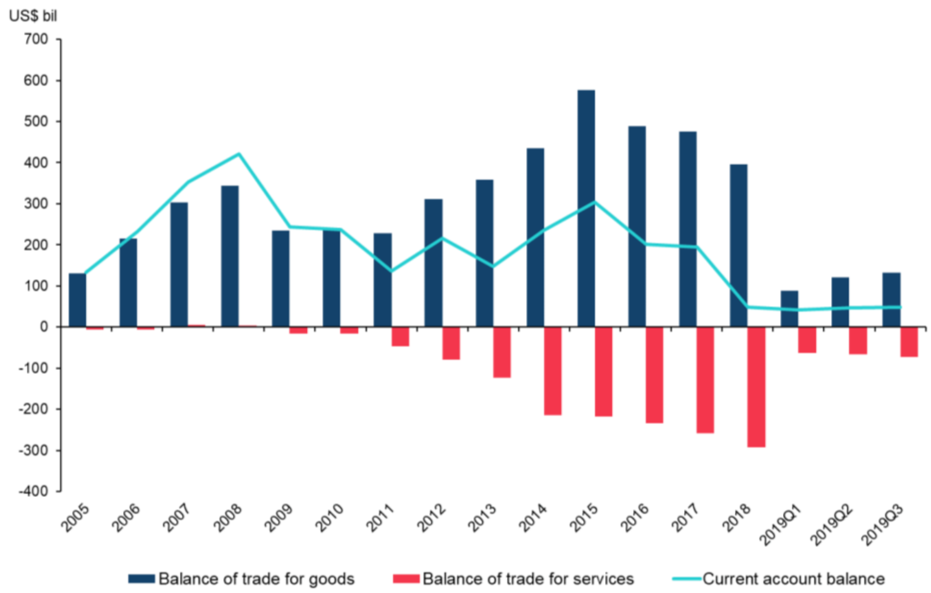
The Mainland's financial opening-up under its Mutual Market Access programme with Hong Kong provides a new channel for Mainland China's in full integration with the world economy, and a safe and controlled environment under which the use of the Renminbi (RMB) in the international community and the opening-up of the domestic financial market can be promoted. It would help facilitate the further opening-up of the Mainland equity and bond markets, hence drawing in global liquidity and promoting the internationalisation of RMB assets, without changing the rules and trading practices in both the domestic and foreign markets, at a time when the RMB is still not yet fully convertible under the capital account.

To cater for the demand for the opening-up of the Mainland financial market, and to better connect with the global market to attract international capital inflows, a globally interconnected RMB financial market needs to be established. Firstly, a new landscape could be explored to achieve RMB internationalisation by "firstly allowing liberalisation of the domestic currency before full convertibility". With the help of offshore RMB centres, such as Hong Kong, the capital account can be opened up firstly for the RMB's circulation, before proceeding onto convertibility between the RMB and foreign currencies. This would reduce the difficulty of opening up the capital account. Secondly, the cross-border use of the RMB that is driven by market demand should be expanded. Hong Kong's strengths as an international and diversified financial centre could be leveraged on, to help funding Belt and Road projects through bond and equity financing, thereby establishing Hong Kong as a pivot for financing the Belt and Road initiative. Thirdly, the synergistic development of capital market opening and RMB internationalisation should be promoted, to facilitate foreign institutional investments in RMB bonds while promoting overseas investments by Mainland investors. RMB financial infrastructures of international standards should also be constructed for global investors, to enhance the Mainland's post-trade capabilities in providing custody, clearing and settlement, and collateral management services.

1. MAINLAND CHINA'S CURRENT ACCOUNT BALANCES: NEW TREND AND FINANCIAL IMPLICATIONS

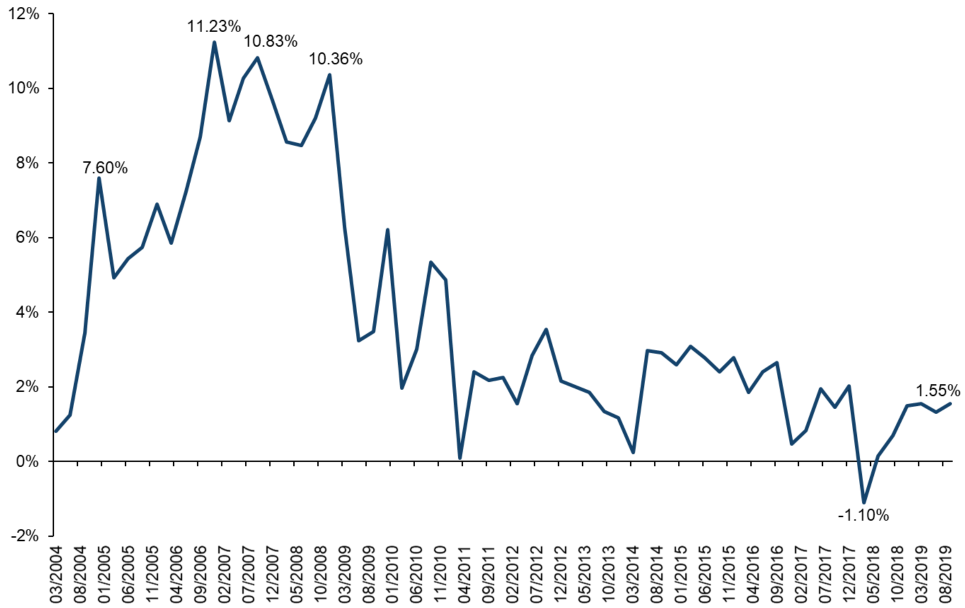
The apparent drop in current account surplus is one of the changes on the current economic and financial fronts in Mainland China that have far-reaching impacts. In 2018, Mainland China's current account surplus fell by 70% year-on-year to US$49.1 billion, bringing its percentage share of the gross domestic product (GDP) to 1.55%. This trend continued in the first three quarters of 2019, with the current account surplus ranging from US$40 billion to US$50 billion, accounting for historically low percentage share of the GDP. Looking back, the ratio of Mainland China's current account surplus to its GDP peaked in 2006 at 11.23%, before retreating gradually and dropped to below 4% (the benchmark level arousing international attention) in 2010. It fell below 2% in 2016 and 2017 and even to a big deficit ever recorded in 17 years in the first quarter of 2018. (See Figures 1 and 2.) It is foreseeable that the ratio would fluctuate within the range of 1%, possibly with slight dips into the negative territory occasionally.

Figure 1. Balances of Mainland China's current account and its sub-accounts (2005 – 2019Q3)



Source: Wind.

Figure 2. Mainland China's current account balance as a percentage of GDP (Mar 2004 – Sep 2019)



Source: Wind.

The gradual shrinking of Mainland China's current account surpluses is significant in that it essentially reflects that the engine of the country's economic growth is shifting from external demands to a combination of domestic and external demands. This represents a substantial change in the country's BoP landscape. With reference to specific current account items, these are trends of the gradually inflating domestic demand, the weakening edge of the low-end processing trade industry and some low-end manufacturing industries going offshore. The merchandise trade surplus will as a result very likely show a structural contraction. On the other hand, with the continuous increase in imports of services driven by the upgrade of consumption, the deficit in service trades would further expand. In the long run, as the rapid aging of the population will mean a lower savings rate, the investment-savings gap will be gradually widened. This will put greater pressure on the current account while undermining the contribution of exports to the long-term growth of the Mainland economy, thereby altering the BoP pattern. **This implies that the consistently large current account surpluses will become history. Mainland China's current account balance may probably fluctuate within a narrow range in the days to come.**

The BoP cycle of the Mainland has basically ventured into a stage marked by a small current account surplus or even a deficit, implying that capital inflows under the capital account are required to support its BoP. This in turn means that the Mainland financial market needs to be further opened up. Apart from this, from a strategic perspective, **the further opening-up of the Mainland financial market and its closer ties with the international financial market can provide certain buffers against the anti-globalisation movement.** Therefore, at the current stage, one of the priorities of Mainland China's financial market reform and opening-up should be how to better connect with the international market and to attract international capital inflows, and to remove obstacles for overseas investors to access the Mainland market.

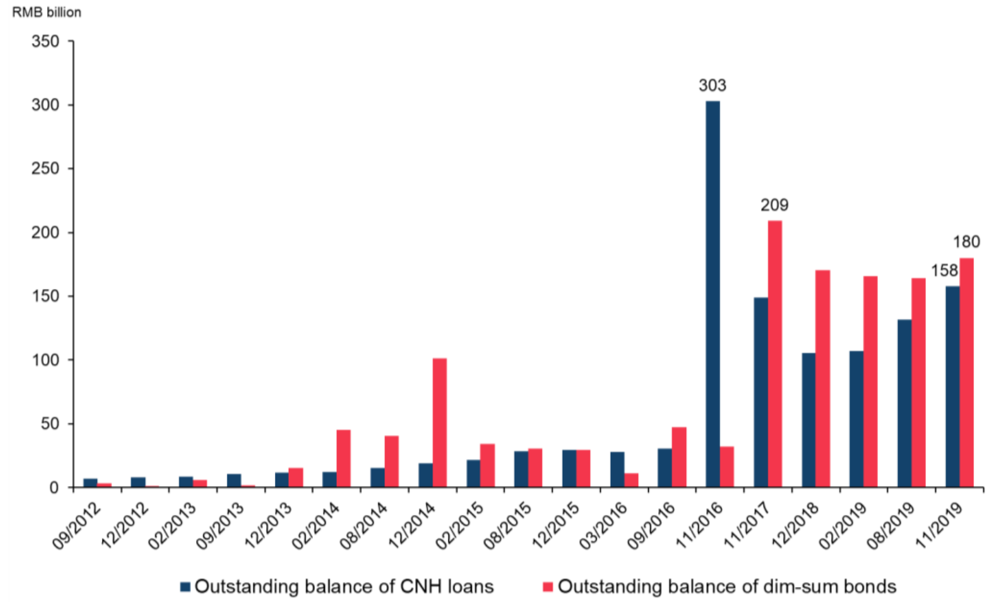
2. THE NECESSITY AND INEVITABILITY OF OPENING UP THE MAINLAND FINANCIAL MARKET

To cater for new demands for opening up the Mainland financial market, Hong Kong can leverage on its unique advantages as a gateway to the Mainland and an international financial centre to perform the "adapter" function between the Mainland and overseas markets in an innovative way, linking up the Mainland with the world under a safe, open and risk-controlled environment. Hong Kong can also explore new ways and models for opening up the Mainland market that best accommodate foreign capital inflows, by establishing more convenient financial infrastructure to support trading, clearing and settlement, and custody, continuing to expand the existing two-way investment channels in the Mainland and overseas financial markets, and introducing a complete financial product suite.

Further opening up the Mainland financial market in the future will go hand in hand with the steady progress in RMB internationalisation. According to international experience, the opening-up of financial markets will not only make up for current account deficit, but also increase cross-border financial transactions. The opening-up of the Mainland financial market would make RMB's attributes as an investment currency more prominent, which implies that the RMB's attributes as an international reserve currency, apart from its being a currency for trade settlement and for investment, will be further enhanced. Key points and challenges to be noted during this transition include the following.

Firstly, how to gradually open up the RMB capital account in a controlled manner. So far, while most of the items in the BoP of Mainland China have become basically convertible or partially convertible, some of the most important items of capital transactions are still subject to strict controls. This mainly involves the following three areas: (1) Approval is required for foreign investment in the Mainland and for domestic enterprises to go global; (2) Mainland Chinese residents cannot take on foreign debts; (3) The Mainland capital market is not yet fully opened to foreign investment. These are the core items in the capital account which not only determine the scale of capital inflows and outflows, but also affect the degree of opening-up of other items in the capital account. In recent years, significant progress has been made in the cross-border use of the RMB, and providing the conditions for capital account items to be settled in RMB. At present, Mainland Chinese residents are subject to certain regulations in respect of foreign liabilities. Nevertheless, indebtedness to foreign parties denominated in RMB is allowed, e.g. dim-sum bonds (bonds denominated in RMB issued overseas) issued in Hong Kong by Chinese companies. During the peak period of 2016 to 2017, dim-sum bonds had an average annual outstanding balance of over RMB 300 billion. In the same period, the balance of Hong Kong's offshore RMB loans also reached a record high of RMB 300 billion (see Figure 3). This shows that the realisation of RMB convertibility under the capital account may take a special path, i.e. relying on offshore RMB centres such as Hong Kong to explore the possibility of opening up the capital account to enable the circulation of the RMB, before achieving the full convertibility between the RMB and foreign currencies under the capital account.

Figure 3. Outstanding balance of offshore RMB (CNH) loans and dim sum bonds in Hong Kong (Sep 2012 – Nov 2019)



Source: Wind.

Secondly, unlike the internationalisation of major currencies in the world, the integration of the RMB into the international monetary system may need to be proceeded without the support of sustainable current account surplus. This may accelerate the progress of the RMB into the stage of "outflow through current account and inflow through capital account", making the attributes of the RMB as a currency for investment more prominent. In the case of the US dollar and the Japanese yen, their internationalisation had involved capital outflows in the domestic currency by increasing investments in and subsidies to developing countries, which had facilitated the internationalisation of local enterprises, products and services, and hence that of the domestic currency. In the United States (US), the Marshall Plan had strengthened the position of the US and the US dollar as an international currency through cross-border enterprise investment and financial cooperation. Similarly, in Japan, the Capital Recycling Programme had achieved the international use of the Japanese yen through encouraging international organisations such as the World Bank and Asian Development Bank to issue bonds denominated in Japanese yen, promoting the outflow of domestic private capital, encouraging Japanese financial institutions to participate in syndicated loans denominated in Japanese yen to provide developing countries with commercial loans in the Japanese yen. The Capital Recycling Programme had also contributed to Japan's BoP. During 1986 to 1990, Japan's trade deficit dwindled year by year from 13.7 trillion yen to 7.6 trillion yen. Alongside, the ratio of the Japanese yen in global official foreign exchange reserves rose steadily from 6.8% in 1987 to 8.7% in 1991[1].

Given the current financial system in Mainland China, in order to expedite the cross-border circulation of RMB to meet market demand and to facilitate the use of the RMB in cross-border trade and investment to a greater extent and to further open up the Mainland capital and money markets, a more market-oriented RMB exchange rate regime will be vital and a more transparent, stable, rule-based, professional and efficient financial regulatory regime will also be crucial. In light of the above challenges, it is necessary to establish a globally interconnected RMB financial market with enhanced depth and breadth to increase the convertibility of the RMB under the capital account so as to better connect with the international market, thereby attracting international capital inflows. The Mainland's financing

[1] See Xu Qiyuan and Chen Lu (2018) "Lesson from the Capital Recycling Programme in Japan: Increasing the use of the RMB in overseas investment" (〈日本「黑字還流」經驗：提高人民幣在對外投資中的使用〉), *China Finance* (《中國金融》), Vol. 5, 2018.

opening-up under its Mutual Market Access (MMA) programme with Hong Kong provides a new channel for Mainland China's full integration with the world economy, and a safe and controlled environment under which the use of the RMB in the international community and the opening-up of the domestic financial market can be promoted. It would help facilitate the further opening-up of the Mainland equity and bond markets without changing the rules and trading practices of both the domestic and foreign markets, at a time when the RMB is still not yet fully convertible under the capital account. Take Stock Connect scheme (comprising Shanghai Connect and Shenzhen Connect) as an example, for the period of from launch to the end of 2019, the total trade value under Stock Connect was about RMB 2.7 trillion while the actual sum of funds remitted across the border was only about RMB 45 billion[2]. This indicates that Stock Connect has achieved relatively small cross-border fund flows in a closed and controlled loop. This connectivity model to promote the internationalisation of RMB assets would be able to attract global liquidity.

3. HONG KONG'S NEW POSITIONING UNDER THE NEW LANDSCAPE OF MAINLAND CHINA'S BALANCE OF PAYMENTS

3.1 Exploring a new landscape of achieving RMB internationalisation by "firstly allowing liberalisation of the domestic currency before full convertibility"

So far, the internationalisation of the RMB has taken a special path that is different from that of other sovereign currencies. Along this part, RMB internationalisation is progressed on before full currency convertibility under the capital account. It relies mainly on offshore RMB centres, such as Hong Kong, for the circulation of the domestic currency under the capital account before proceeding onto convertibility between RMB and foreign currencies under the capital account. In this way, the difficulty of opening up the capital account can be reduced.

In the context of RMB internationalisation, exchange rate issues are closely related to interest rate issues. If a more effective interest rate corridor can be built up to form an efficient short-term interest rate transmission mechanism and a short-term yield curve, then given the spontaneous adjustment by market forces, the short-term market interest rate will fluctuate around the medium-to-long term benchmark interest rate, driving reasonable Mainland liquidity flows across the border, thereby ultimately reaching an equilibrium between onshore and offshore liquidity. To form a long-term parity relationship between the interest rate and the exchange rate, it is necessary to further facilitate the connection between the onshore and offshore markets of the RMB. By allowing foreign funds to invest in the Mainland financial market using RMB, and domestic funds to invest in foreign financial markets using RMB, the RMB exchange rate and RMB interest rate would have integrated mutual effects on each other. This would make RMB interest rates applicable to RMB assets inter-connected across the world, and enable the monetary policies of the Mainland central bank (the People's Bank of China) to have direct or indirect influence on these global assets in RMB.

To achieve this goal, it is essential to carry out a deepened reform by proactively and steadily promoting the opening-up of the financial industry in Mainland China in accordance with a reasonable priority and expanding the scope of financial opening-up. The key points of the reform include:

(1) Accelerate the process of marketisation of RMB interest rates, and build a fixed-income market and a derivatives market centred around the yield curve of government bonds with rich product varieties and a reasonable combination of maturities.

[2] Source: HKEX.

(2) Encourage the further development of free trade zones (FTZ), facilitate their interaction with offshore RMB centres for achieving RMB convertibility under the capital account, and summarise experience for future replication and expansion.

(3) On the basis of the experiences of Stock Connect and Bond Connect, Hong Kong can continue to explore a controlled model for opening up the Mainland financial market and widen the scope of the MMA programme to include more forms of financial products such as "Derivatives Connect", "Primary Connect", etc., thereby helping the Mainland achieve basic RMB convertibility under the capital account by leveraging on Hong Kong's special position. At present, the International Monetary Fund (IMF) does not have definite requirements on capital account convertibility, a capital account that achieves a certain degree of currency convertibility for a certain range of indicators will be considered as basically convertible. If the risk-controlled channel of the MMA mechanism with Hong Kong can be leveraged on in the near future to achieve further policy breakthrough for the three remaining sub-capital accounts that have not realised RMB convertibility, i.e. achieving basic capital account convertibility, Hong Kong's role as the intermediary in the RMB internationalisation process will be reinforced. This in turn would promote the trading and circulation of more RMB-denominated financial products in the international market.

(4) Certain existing policy pilot programmes can be combined with RMB internationalisation. For example, in December 2017, the China Securities Regulatory Commission (CSRC) announced the launch of an H-share "full circulation" pilot programme[3] to provide a new platform for the integrated reform of state-owned enterprises and new opportunities to draw in overseas capital. For issues involving cross-border capital flows, the "full circulation" of H shares can be liberalised as appropriate and money settlement in RMB could be considered to alleviate exchange rate fluctuations upon "full circulation" of H shares. The investment attributes of offshore RMB assets have significantly improved in recent years, providing more desirable investment choices for RMB funds. On this basis, the regulator may consider to set certain quota to allow cash realised by shareholders of "domestic shares" to be invested in offshore RMB assets in Hong Kong. This would help resolve, to a certain extent, the cash-in problem faced by shareholders of "domestic shares", and help meet the shareholders' need for overseas allocation of funds. This will also reinforce the valuation and settlement functions of the RMB in overseas financial markets, and further improve offshore RMB liquidity.

3.2 Expand the cross-border use of the RMB that is driven by market demand

The growing trade and investment ties between Mainland China and countries along the Belt and Road have provided golden opportunities for the circulation and use of the RMB in these countries. With the inclusion of RMB assets in the foreign exchange reserves of the central banks of Russia, Singapore, Thailand and other countries, the RMB has started to perform its "store of value" function in a number of Belt and Road countries. The RMB is expected to become one of the important currencies in trade finance given the continued tightening of the monetary policy in the US. The average annual trade volume between Mainland China and countries along the Belt and Road is expected to exceed RMB 16.85 trillion (US$2.5 trillion) in the next 10 years from 2017[4]. Furthermore, part of the financing required for Belt and Road projects will be partly denominated in RMB. This would expand the scope of RMB products and attract enterprises to use RMB to settle cross-border trades and for cash management, investment and financing transactions. Policy makers may consider broadening the scope of the use of the RMB in the Belt and Road region in the following three aspects: firstly,

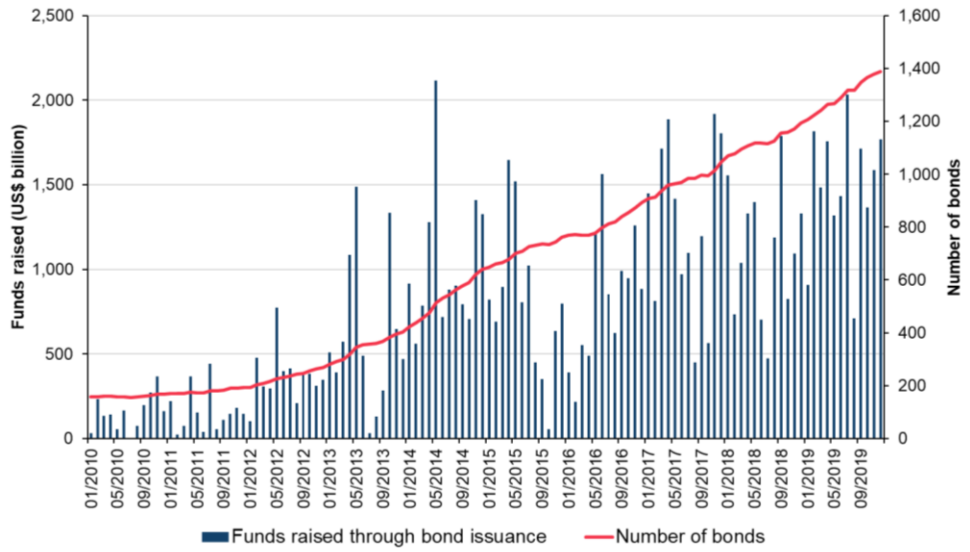
3 Source: "The Implementation of H-Share full circulation pilot programme to deepen the reform of overseas listing regime" (〈深化境外上市制度改革開展 H 股「全流通」試點〉), issued by the CSRC, CSRC's website, 29 December 2017.

4 Source: "Belt & Road between China and ASEAN, creating opportunities for development" (〈中國東盟一帶一路　締造發展良機〉), Hong Kong Trade Development Council's website, 2 March 2017.

expediting the construction of RMB clearing networks in the Belt and Road countries; secondly, guiding the establishment of offshore RMB markets in the Belt and Road countries; thirdly, further magnifying the radiating effect of the financial centres along the Belt and Road, especially international financial centres such as Hong Kong, to provide comprehensive cross-border RMB services for regional trade and financial cooperation.

For the third aspect, Hong Kong's strengths as an international and diversified financial centre can be leveraged on to help funding Belt and Road projects through bond and equity financing, thereby establishing Hong Kong as a pilot of a financing and "financial magnifier" for the Belt and Road initiative. In view of the fact that the Belt and Road initiative is just at its start and of the nature of infrastructure projects under the initiative, the major financing needs at the initial stage would mainly be debt financing, meaning that issuing bonds is a necessity for financing of Belt and Road projects. In recent years, Chinese enterprises' issuance of USD-denominated bonds and dim-sum bonds has become prevalent in Hong Kong. In 2018, funds raised by debt securities newly listed on the securities market of the Hong Kong Exchanges and Clearing Limited (HKEX) reached US$134.48 billion. For 2019 up to the end of September, funds raised by bonds on the market totalled US$131.74 billion and the month-end number of listings reached 1,347 (see Figure 4), making Hong Kong an important bond financing market in Asia. In addition, in the progress of Belt and Road projects or upon their completion, these projects may also seek a listing on the Hong Kong stock market, and tap into the Mainland's domestic capital investment through Stock Connect, thereby achieving global portfolio diversification of Mainland China's capital. This would facilitate the continuous investment in, and the financing of, Belt and Road projects and increases liquidity in asset transactions.

Figure 4. Month-end number of listed bonds and monthly funds raised by bonds on HKEX (2010 – 2019)



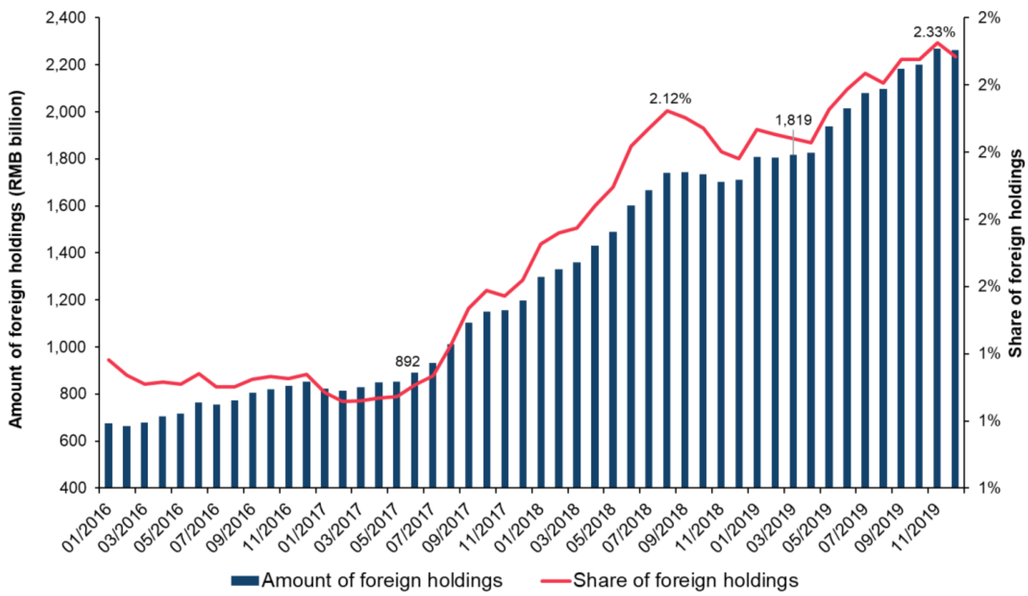
Source: Wind.

3.3 Synergy between capital market opening and RMB internationalisation

The internationalisation of the RMB hinges on a well-developed capital market. When the capital account becomes fully open in the future, the stock market and bond market will provide an important trading, clearing and settlement platform for the outflows and inflows of the RMB. Through continued development of a deep market for RMB-denominated financial products and consolidating the construction of financial infrastructure for cross-border transactions of RMB assets, the value of RMB assets would be enhanced in the sense of a global allocation perspective. This would increase the demand for RMB in overseas investments.

Firstly, with reference to the US' experience, the outflow of RMB can be promoted by allowing foreign institutions to issue RMB-denominated bonds in Mainland China whereas the inflow of RMB can be promoted by issuing RMB-denominated bonds overseas to foreign investors. In recent years, the Mainland bond market has been increasingly opened up to facilitate the participation of foreign investors. Available major access channels are qualified institutional investors for direct participation in the China Interbank Bond Market (CIBM), Qualified Foreign Institutional Investors (QFIIs), RMB Qualified Foreign Institutional Investors (RQFIIs) and the Northbound trading under Bond Connect. In 2018, the Bond Connect platform in Hong Kong had its functions further upgraded in response to international investors' requests. These include the full implementation of delivery versus payment (DvP) for settlement, the launch of the trade allocation function, further clarification of related tax policies and the addition of Bloomberg as the second trading platform for Bond Connect trades after Tradeweb. Thanks to these measures, the average daily transaction volume of Bond Connect reached RMB 12.9 billion in 2019 and the number of investors registered reached 1,311 (including financial institutions and the investment management companies of investment products), covering 31 countries and regions around the world[5]. As a result of such great improvement in the convenience provided for foreign institutional investors to invest in RMB bonds, the proportion of bonds held by these investors in CIBM has also risen significantly (see Figure 5).

Figure 5. Amount and percentage share of foreign holdings in CIBM (2016 – 2019)



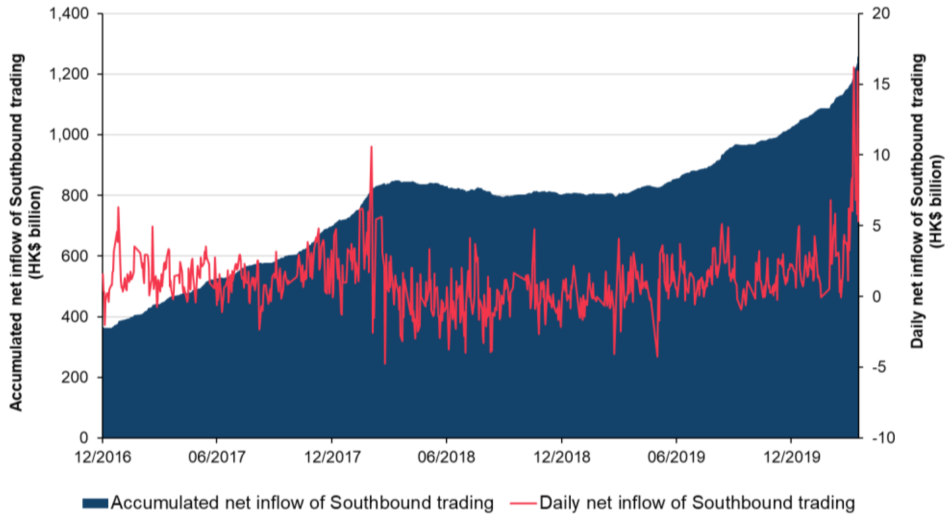
Source: Wind.

Secondly, in parallel, the Mainland should contribute to encourage overseas investment by domestic investors, to gradually accomplish the goal of Mainland capital being invested in overseas multiple asset types through multiple channels, such as Qualified Domestic Institutional Investors (QDIIs). Given its unique role as a financial centre connecting the Mainland with the financial markets of the world, together with its well-developed financial system and MMA framework, Hong Kong can provide a transparent, safe and controlled environment for Mainland residents to realise global asset allocation. When global markets experienced high volatility in the first quarter of 2020, Mainland capital continued to flow into the Hong Kong stock market via Southbound trading under Stock

5 Source: Website of Bond Connect Company Limited.

Connect, recording historical high of inflows (see Figure 6). On 13th and 19th March 2020, the daily net Southbound inflows exceeded HK$10 billion[6], reflecting that Chinese capital is making full use of the convenience of the MMA scheme to carry out global allocation. On the bond market, Southbound trading under Bond Connect could be launched at the appropriate time when the relevant preconditions are met. This would help further facilitate the alignment of the Mainland financial market operations with international standards, and could gradually liberalise the restrictions over the price linkage and arbitrage transactions between domestic and overseas markets, thereby maximising foreign participation in the Mainland market.

Figure 6. Daily net inflow and accumulated net inflow of Southbound trading under Stock Connect (5 Dec 2016 – 20 Mar 2020)



Source: Wind.

Third, RMB financial infrastructures of international standards should be constructed for global investors to enhance the Mainland's post-trade capabilities in custody, clearing and settlement, and collateral management services. The existing custody, clearing and settlement systems in Mainland China are very different from international common practices. To address this issue, it maybe considered to build up financial infrastructures in Hong Kong that are in line with international practices for RMB transactions, and to advance mutual access in the exchange-traded bond market. Together with the set up of a cross-border RMB custody, clearing and settlement system to provide issuance, custody and clearing and settlement services for RMB-denominated international and regional bonds, the institutional barriers for transactions like pledges and repurchases of RMB assets could be removed, thereby establishing a complete core network of international standards for the cross-border circulation of the RMB.

[6] On 13th and 19th March 2020, the daily net Southbound inflows were HK$16,171 million and HK$15,906 million respectively.