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Measuring Value®
The RMB: Savings and investment surge

Promoting an international role for the RMB serves Beijing's interests in many ways. Both the prestige and the financial muscle that results from being able to print money that is recognised regionally would help secure and sustain China's dominant role in the region's development. It would strengthen the synergies between Chinese foreign aid, global lending, and its own economic growth, and it would add efficiency to the regionalisation of production sharing networks and trade that is increasingly important for the region to remain hyper-competitive in global trading and finance networks. Just considering China's dependence on imported commodities and exported manufactured goods, the great value of expanding the RMB's utility beyond China's borders is obvious.

After a few years of the Beijing government's project to propel the RMB into an international role, we recently witnessed a surge in RMB accumulations outside of the Chinese Mainland and expressions of new interest across Central Asia and as far as Russia. The Hong Kong Monetary Authority reported in 2010 Q3 that deposits of record in Hong Kong reached RMB217.1billion, a rise in October 2010 of over 45 percent. Estimates now put the total of RMB300 billion in Hong Kong. Officially measured RMB deposits outside of China grew 400 percent in the first 11 months of 2010, by an estimated RMB150 billion, about 2/3 of which are in corporate accounts, with the remainder in individual accounts. From all available viewpoints, this is a dramatic surge.

The primary goal of the international role programme was and remains to make RMB an efficient and welcome currency for trade settlement.

But recently more and more arguments have been made that trade settlement cannot be separated from investment expansion, as large accumulations outside the Chinese Mainland look for returns commensurate with those available for RMB in the Mainland and commensurate with other currencies

This challenges China's long established policies and regulations that clearly differentiate trading transactions from capital transactions.

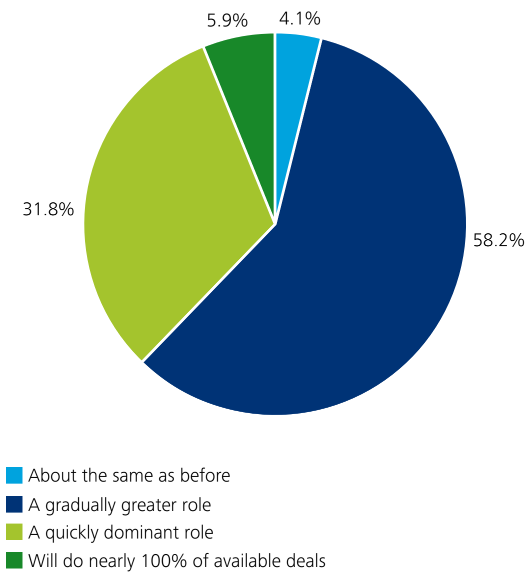
From a business perspective, what is the current business situation and the implications of current changes for operations in China and Asia. What are the expectations of financial and investment experts? We look at three major forces at work on the RMB presently and some important new opportunities for investors that result.

First, the surge in liquidity in China since the global financial crisis has been paralleled with a liberalisation of financial services, so much so that as many as 3,000 PE funds or PE-like funds are operating in the Mainland.

Surveys of fund managers show their expectations are that RMB funds will dominate the pre-IPO investment activity in the Chinese Mainland

They are quick in decision making, relatively unburdened with the red tape involved in currency conversion, and most have very helpful political alignment supportive of the deals they seek to make. There is some irony and something of a dilemma in this situation; as China attempts to project the RMB abroad, its own channels of capital are trending strongly toward a more totally domestic enclave. In polling Deloitte conducted at the recent Asian Financial Forum 2011 in Hong Kong, with about 550 people attending the workshop and nearly half participating in the poll, over 58 percent responding expected RMB funds in the Chinese Mainland to play a gradually expanding role, and another 32 percent expected them to play a quickly dominant role. Over 5 percent expected them to do almost all of the Mainland deals, and a miniscule 4 percent expected them the play about the same role as before (Refer to Chart 1).

Chart 1: What role do you expect domestic RMB funds to play in the next three years in pre-IPO investment in the Mainland?



While on the early-stage investment side this is a turning inward, its ultimate impact will be to open the door further to cross-border capital transactions.

The robust growth in pre-IPO RMB fund investment adumbrates a growth in the number of investors seeking exits with RMB proceeds

The capacity of the on-shore boards to support the surge of anticipated exits is open to question for two reasons. The main board listing requirements are not as hospitable to growth companies as the ChiNext, which was purpose-built for growth companies. But the ChiNext is being carefully managed to prevent a deterioration of its credibility, akin to what happened to the AIM market, and it now has as much as a two year wait to gain approvals. That careful management involves close scrutiny of compliance with listing requirements plus a balanced metering of supply into the fledgling board so as not to overwhelm investor demand and depress the alluringly high multiples many sectors have enjoyed. The history of the ChiNext is too short to make a confident assessment of how strong its investor base is, but there would be risk in a sudden expansion to two or three times the current pace of listings.

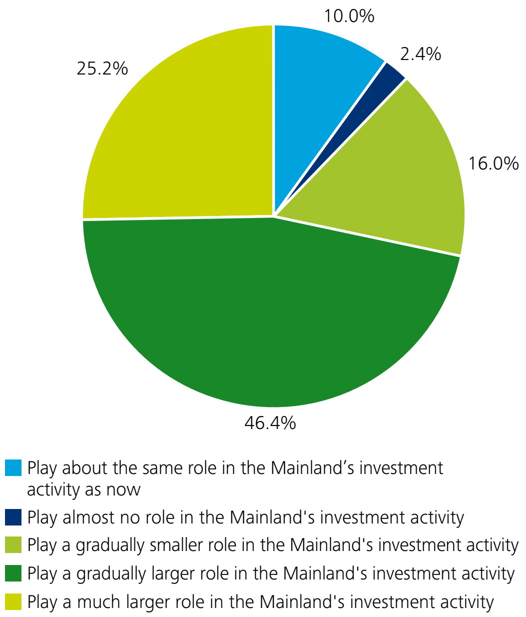
Finally there is Hong Kong, where RMB have accumulated at an ever-quickening pace in both individual and enterprise accounts, primarily driven by the expectation it is a currency that will appreciate against the dollar and the Euro. But that expectation has been somewhat dampened by Beijing's professed and persistent claims that its adjustments of the RMB's exchange rate will be gradual, primarily attuned to domestic concerns about stability, inflation, and export competitiveness.

As a result of dampened expectations of a dramatic exchange rate adjustment, the low current returns for RMB held outside the Mainland have become a concern

Hong Kong banks offer a fraction of the interest rates available to Mainland depositors, and even government and corporate bonds sold in Hong Kong and denominated in RMB pay considerably less than similar products in the Mainland. In fact, the difference in potential returns and the need to control resultant hot money flows into the Mainland have given rise to recent policy moves on some on-shore accounts owned by foreign interests that are more restrictive, not liberalising. An example is the People's Bank of China (PBOC) instruction to Mainland banks disallowing Non-resident RMB accounts (NRA) in the Mainland from making term deposits at attractive interest rates. NRAs can only hold funds in demand accounts, with much lower deposit interest rates than those available to resident account holders.

Bringing together these forces, with a potential bottleneck in IPO exits in the Mainland, and a surplus of low-earning RMB in Hong Kong, there is obvious pressure on existing capital account regulations that separate RMB activity in the Mainland and outside, and there is clear progress in expanding cross-border capital investment opportunities. Our Asian Financial Forum poll respondents saw this clearly. Over 46 percent saw Hong Kong capital playing a gradually larger role in Mainland investment activity, and another 25 percent saw it playing a much larger role (Refer to Chart 2).

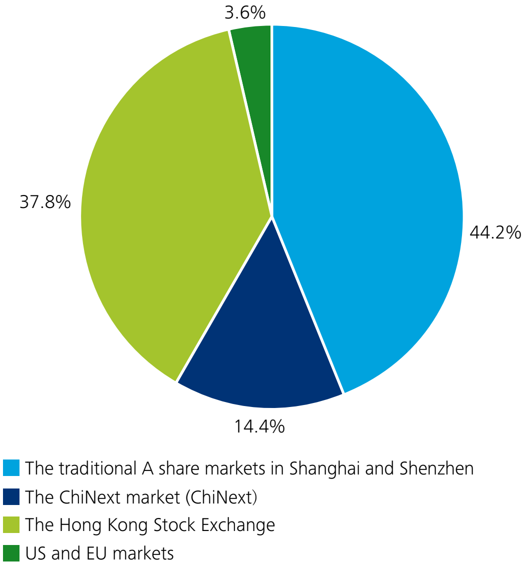
Chart 2: In the next three years, capital from Hong Kong in both RMB and other currencies, will:



Implicit in these results is the expectation that regulators will permit new channels through which RMB can reenter the Mainland from the outside, such as the mini QFII scheme that has been under discussion.

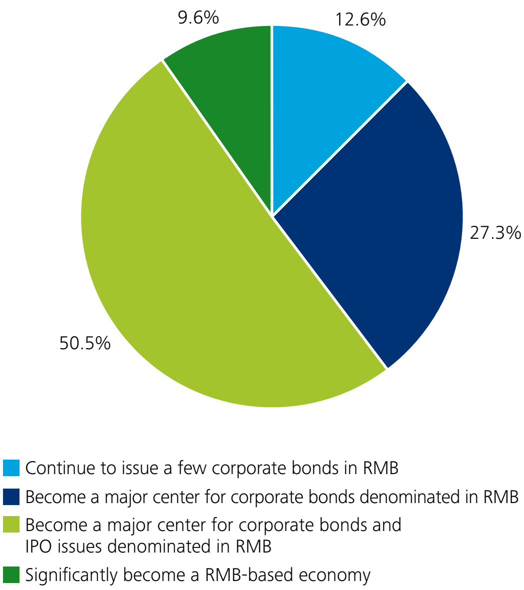
But another part of the solution will be an expansion of RMB-denominated investments in Hong Kong and other markets outside the Mainland. Our poll respondents expect nearly 38 percent of Mainland companies accepting pre-IPO funding from RMB sources will see exits on Hong Kong exchanges, not much fewer than the 44 percent that expect such exits to be on the established A-share main boards in the Mainland (Refer to Chart 3).

Chart 3: For Mainland companies that accept investment from RMB-based funds, their most likely markets for exits through IPOs will be:



Seen from the perspective of the Hong Kong investors, and global investors who operate in the Hong Kong financial markets, 78 percent expect Hong Kong to be a major issuer of RMB-denominated corporate bonds and/or RMB denominated IPOs within three years. That is an example of very fast adaptation of Hong Kong's financial markets (Refer to Chart 4).

Chart 4: Within 3 years, Hong Kong will:



Imbalances that exist in the current situation will drive regulatory change, but they also create some interesting opportunities for regional business development. For several reasons, not all RMB wants to return to the Mainland. As regulators permit more RMB-denominated products to be sold in Hong Kong so as not to dampen the off-shore enthusiasm for transacting and holding the currency, businesses will innovate with new financial services and products, arbitrage activities, and new trading activities.

The idea has been discussed recently of how the expansion of RMB financial products in Hong Kong is likely to develop. One view is that there will be a process of at least three phases, from most stable to most volatile RMB products. The first phase is underway, with fixed interest products like government and corporate bonds. The next phase is imminent, with variable return products, but based directly on somewhat stable assets such as real estate investment trusts and mutual funds with underlying holdings in Mainland A-share equities. The final stage is ordinary equities of mature or growth companies. There are many regulatory issues that need to be addressed before proceeding to the final stage.

MNCs operating in China and across Asia can explore several opportunities that result from the market imbalances and regulatory pressures that currently exist

RMB financial products in Hong Kong began with limited offerings of government and SOE corporate bonds, primarily for SOE banks, but recently have become open to MNCs. An unintended consequence of the limited investment options for RMB investments outside the Mainland and low returns is that MNCs can access very inexpensive RMB in the Hong Kong corporate bond market, for a variety of purposes, like funding financial services on the Mainland (such as leasing) or funding facility expansion (such as retail facility build-out). A second opportunity is to expand treasury commitment to the RMB, utilising it for regional trade settlement and maintaining some accumulations as a way to add efficiency to regional trade within supply chains and as a hedge against currency shifts in the future. A third opportunity is to plan RMB stock sales in Hong Kong, for Mainland Wholly Owned Foreign Enterprises (WOFEs) or joint ventures or regional holding companies, where familiar IFRS reporting standards are accepted and international listings are already significant and growing more so. While the discussion of an international board in Shanghai continues, as a discussion, there is the prospect that non-Chinese companies could list in RMB on Hong Kong exchanges.

We believe these developments in the RMB may be very significant in maintaining competitiveness in both sourcing and market development in China and the region. As soon as China joined the WTO in 2001, Chinese trade negotiators went to work to build a network of Free Trade Agreements (FTAs). Many key FTAs went into effect January 2010, and surveys of Chinese enterprises show that a majority of large enterprises take advantage of them, especially in with the Association of Southeast Asian Nations (ASEAN) trading partners. In the last few years, we have seen a small but steady growth in Chinese outbound investment into the FTA network countries, which we believe is part of enterprise initiatives to optimise production sharing networks and marketing networks, especially as Chinese labour costs inflate and S.E. Asian markets expand.

Increasing regional use of the RMB is an essential complement to the FTAs in knitting together China and regional activity and remaining competitive in the fastest growing part of the world

And that alone merits a look at existing and prospective options for remaining fully informed and active in developing a focused currency strategy in the region.

Contacts

If you have any queries on this issue, please contact one of our professionals:

Beijing

Ken Dewoskin
Director
Deloitte China Research and Insight Centre
Tel: +86 10 8512 5601
Email: kdewoskin@deloitte.com.cn

Wang Peng-Cheng
Partner
Audit
Tel: +86 10 8520 7123
Email: wangpc@deloitte.com.cn

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