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As Australia's largest business bank, we work with small, medium and large businesses to help them start, run and grow. We fund some of the most important infrastructure in our communities — including schools, hospitals and roads. And we do it in a way that's responsible, inclusive and innovative.

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RMB *Roadmap* 2018

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RMB INTERNATIONALISATION: SEQUENCING IS THE NAME OF THE GAME

In its own unique and meandering manner, the People's Bank of China (PBoC) seems to be providing important clues about how it manages the RMB, and where it sees RMB liberalisation and consequent internationalisation heading in the next few years. However, there are very real interim steps that need to be taken to prepare the domestic scene for the onslaught of volatility that will accompany a full opening up of the financial account.

Of course, the endgame is for the RMB to be a truly global currency on par with the USD and EUR, but that's a long way off. Given the need for intermediate preparatory steps though, the 2020 target of financial account opening is not likely to be met. What we might be able to see by then is greater international access for the domestic equity and bond markets. This increased access might be enough to secure RMB assets a more representative weight in the key global equity and bond indices (MSCI and JPM EMBG).

However, chances are that the currency will still be fairly controlled as the financial sector prepares to cope with the surging ebb and flow of global capital flows. For the time being, the existing system of offshore clearing houses providing external access to the currency, while stock and bond connects provide access to those markets, will prevail.

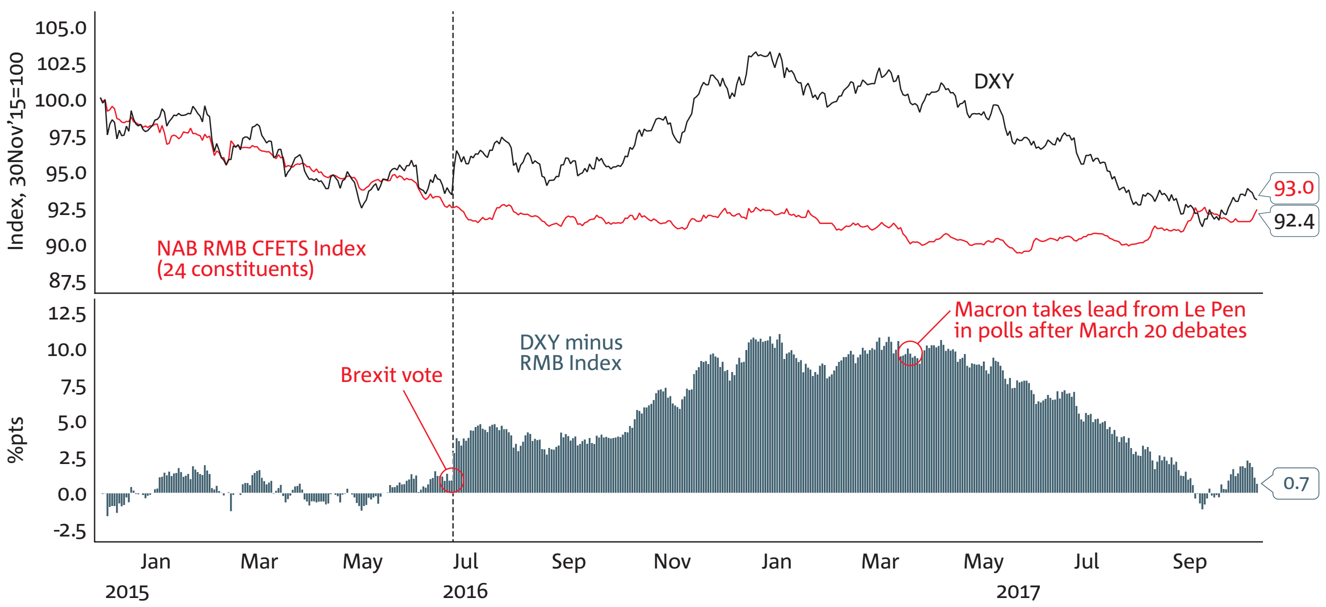
Clarity on the FX management regime

Since the USD/CNY fixing mechanism was tweaked in August 2015 and the China Foreign Exchange Trading System (CFETS) started to quote a trade-weighted nominal effective exchange rate (first with 13 components, then later expanded to 24 components), the FX regime that the authorities were using to manage the RMB was a bit of a mystery.

That the move also coincided with the 30 November 2015 announcement of the RMB's admission into the exclusive International Monetary Fund's (IMF) Special Drawing Rights (SDR) basket added to the confusion. The inclusion was something that Beijing was very keen on and there was the belief that the authorities were willing to relax its control on the RMB as a quid pro quo.

The third quarter of 2017 has proved to be particularly revealing on this front. The cumulative differential between the USD Index (DXY) and the RMB index (RMBX) – both indexed to 30 November 2015 – dipped back into negative territory and has since been kept in a fairly tight range around the zero percentage point difference. This suggests quite strongly that the PBoC has reverted back to the management regime that had been in place before the surprise Brexit vote on 23 June 2016.

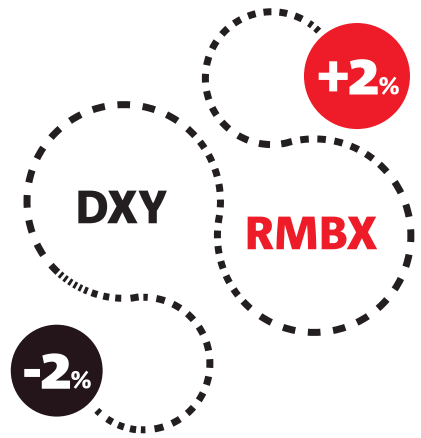
Chart 1: DXY-RMBX differenial seems to be the FX policy target



Source: National Australia Bank, Bloomberg, Macrobond

For the almost 7 months prior to the Brexit vote, the PBoC had kept the RMBX close to the DXY on a cumulative basis right up to the eve of the vote. After that surprise event, the DXY was allowed to open up a gap with the RMBX, and this was allowed to widen even further after the surprise election of Donald Trump in November 2016. The gap peaked in the January-March 2017 period at around 10 percentage points before starting to narrow decisively around the time of the first debate in the French presidential election on 20 March 2017.

The changes in the DXY-RMBX gap over the last 24 months, and the fact it that was completely erased within 6 months was surprisingly quick, and has a few important implications:



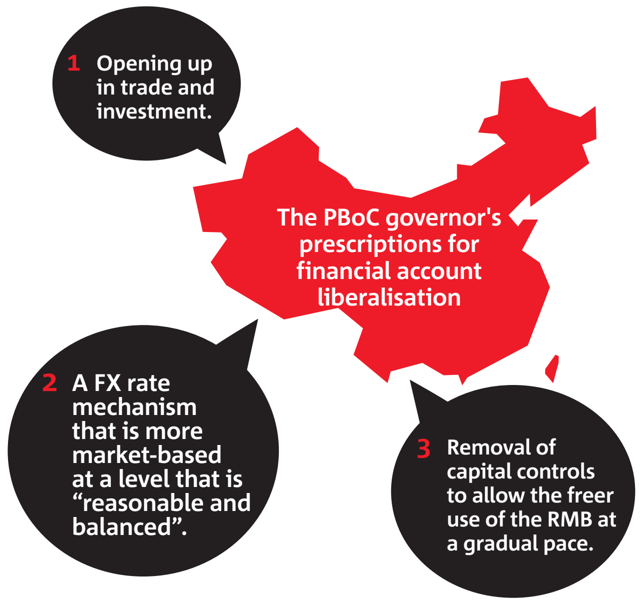
1. The DXY-RMBX gap appears to be the target variable of the current FX policy regime, and a -2 to +2 percentage point band about zero seems to be the default setting.
2. The authorities are not afraid to effectuate fairly sharp moves in the index in response to perceived changes in the global risk levels.
3. The authorities appear to be satisfied that the contagion risk from Europe has abated for the time being and barring any serious spike in risk, the RMBX is likely to track the DXY fairly closely.

This sets the stage for a gradual but sustained rise in the comfort level of foreign investors and reserve managers. What would further help that process along is some clarity on the path forward with regards to the liberalisation of the financial account, and increasing foreign access to domestic capital markets. Comments by key officials before and during the latest Communist Party Congress have provided key insights into the authorities' plans on this.

Sequencing is the name of the game

While significant progress has been made on liberalising both the currency, and opening up the onshore bond and equity markets, there are other structural reforms that need to happen before the floodgates can be thrown open. In a fairly revealing interview with the People's Congress, PBoC Governor Zhou Xiaochuan outlined his thinking on liberalisation going forward.

Zhou said that China needs to liberalise its economy, reform the currency, and relax capital controls, all in a "comprehensive" manner. He also listed three key drivers of further economic liberalisation:



These measures are not entirely new but of particular interest were Zhou's comments about timing: China needs to "pay attention to the time frame for reforms" and that some can be accelerated "when the time is right". This is reflective of the gradualistic approach that Beijing has taken with reforms in general and the liberalisation of the RMB in particular.

This approach is in line with recent IMF recommendations. In a paper titled “The liberalisation and management of capital flows” from November 2012, the IMF warns that:

1. Capital flow liberalisation is generally more beneficial and less risky **if countries have reached certain levels or “thresholds” of financial and institutional development**. In turn, liberalisation can spur financial and institutional development.
2. **Liberalisation needs to be well planned, timed, and sequenced** in order to make sure that its benefits outweigh the costs, as it could have significant domestic and multilateral effects. Countries with extensive and long-standing measures to limit capital flows are likely to benefit from further liberalisation in an orderly manner. There is, however, no presumption that full liberalisation is an appropriate goal for all countries at all times.

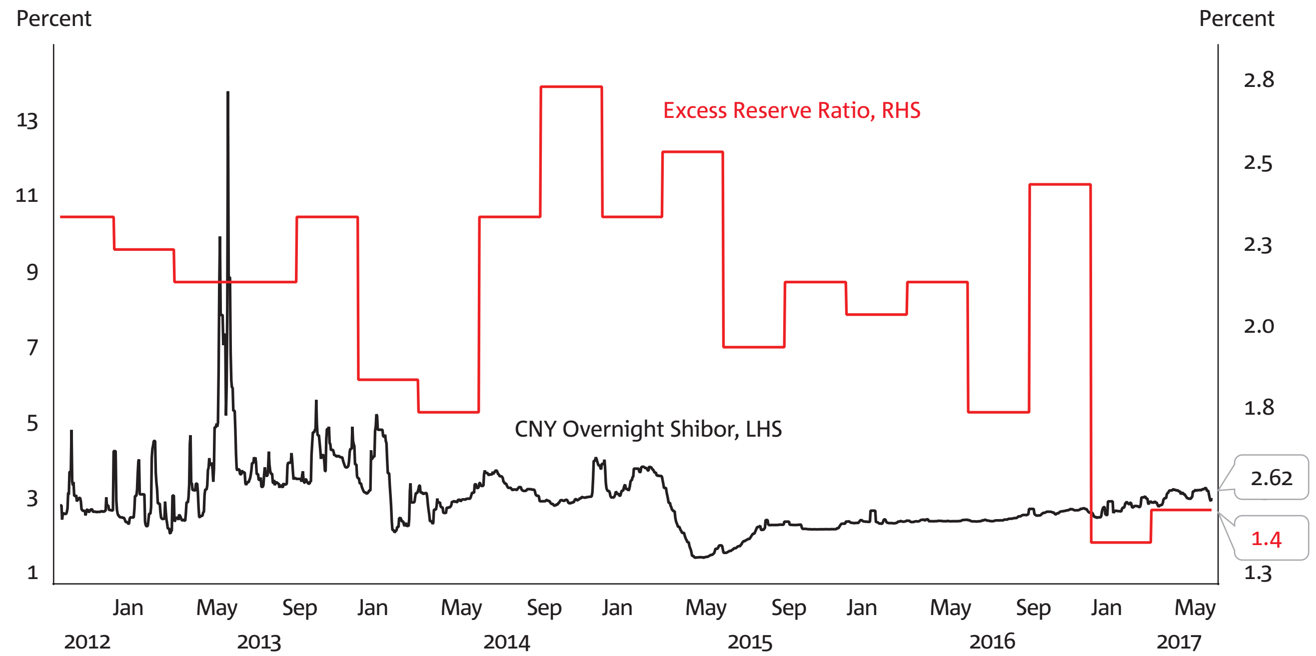
In the same interview, Zhou went on to elaborate on the need for further liberalisation of China’s financial sector, advocating for more market entry and foreign participation in banks, brokerages and insurance. Interestingly, Zhao also mentioned the “historical burden” on the banking sector, a likely reference to the risk that years of acting as policy banks has left banks uncompetitive and ill-prepared to deal with the volatility of a liberalised system.

One previous episode that perhaps provides some colour to this “historical burden” is the series of overnight Shanghai Interbank Offered Rate (Shibor) spikes in 2013, when the rate hit a peak of 13% when the PBoC on multiple occasions throughout the year declined to inject liquidity into the interbank market in an effort to spur banks to deploy their excess reserves held on top of required reserves. At the point of the peak in the overnight Shibor, banks were holding 2.1% of excess reserves on top of the 20% required reserves. A statement from the PBoC released around that time actually complained about the seasonally “relatively high level” of RMB 1.5 trillion of excess reserves.

The authorities essentially acknowledged the failure of the experiment by reverting to closely managing the Shibor market from mid-2014 and this has remained the case ever since. This dysfunctional interbank market is reflective of the both fact that Chinese banks do not seem to have developed a sophisticated enough liquidity management system, and is symptomatic of the “historical burden” that Zhou alluded to.

Addressing this issue will require significant reforms to both the banking system as a whole and to the domestic deposit banks, especially the largest ones. This could prove to be the biggest test of the authorities commitment to the reform agenda.

Chart 2: Overnight Shibor spiked in 2013



Source: National Australia Bank, Macrobond

If you love them, let them go

While the authorities have shown an ability to take the pain of a stronger and more volatile currency, slower growth, and stock market plunges, what has proved elusive so far is evidence of an ability to accept a reduction in the amount of discretionary control that they wield. In June 2017 Governor Zhou had opined openly that too much protection for domestic institutions will weaken the industry and could lead to financial instability.

Before Zhou’s interview in October, news reports had indicated that internally, the PBoC and China Banking Regulatory Commission (CBRC) actually began to seriously consider measures to open up the USD 40 trillion financial sector in September 2017. This follows the declaration of intent by the State Council, in August, to continue to support the opening up of various sectors including banking, securities and insurance to foreign investment.

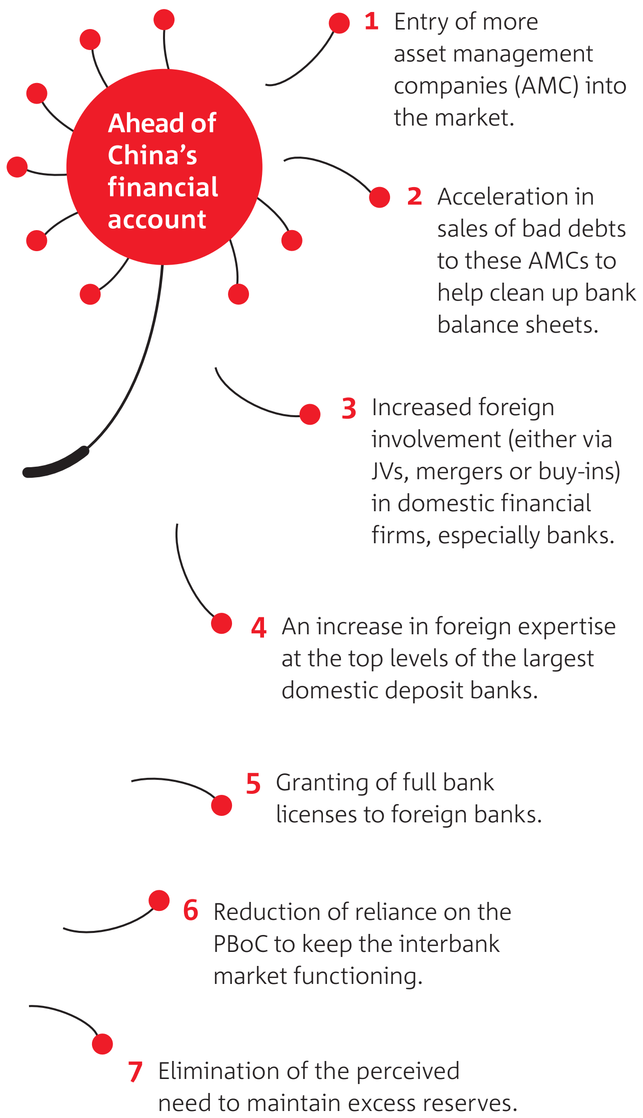
According to news reports, the PBoC and CBRC are specifically considering measures that include:

1. Allowing foreign institutions to control their local finance sector joint ventures (JV);
2. Raising the current 25% ceiling on foreign ownership of Chinese banks;
3. Allowing foreign firms to provide CNY-denominated bank card clearing services.

Currently, foreign investment banks are limited to minority stakes in their local securities joint ventures, and are mostly excluded from lucrative businesses such as secondary market trading in Chinese debt and equities, and wealth management. The 2016 removal of the ban on domestic investment firms being 100% foreign owned should provide some encouragement for those eagerly anticipating further liberalisation.

The comments by Governor Zhou and the measures that the regulators are supposedly considering show quite clearly that there’s an understanding that the domestic financial sector needs to be strengthened ahead of a full opening up of the financial account and allowing full foreign access to onshore bond and equity markets.

As the IMF had cautioned, “in order to strengthen countries’ capacity to absorb and manage inflows and outflows, their financial systems need to be able to mediate flows safely, allow firms to access capital to finance productive investment, and give households and firms the ability to diversify their portfolios while managing the risks”. To that end, amongst the potential signals that one should expect to see ahead of China’s financial account being fully opened up are:



Given that there is still quite a bit to be done in terms of bolstering the resilience of the financial sector, the erstwhile target of fully opening up the financial account by 2020 is looking to be a bit difficult. However, as the IMF warned, “there is no presumption that full liberalisation is an appropriate goal for all countries at all times. The degree of liberalisation appropriate for a country at a given time depends on its specific circumstances, notably its financial and institutional development.”

BELT AND ROAD INITIATIVE: REVIVAL OF THE SILK ROAD

China's Belt and Road Initiative (BRI) is nothing if not bold and ambitious, both in terms of vision and raw numbers. Pitched as a revival of the historic Silk Road, the BRI is set to connect countries that in total account for 62% of the world's population, 34% of global merchandise trade and 31% of world GDP. The McKinsey Global Institute projects that the BRI region could account for 80% of global GDP by 2050, with the project pushing another 3 billion people into the middle class. Across 6 economic corridors, spending is projected to total around USD 900 billion, much larger than the USD 130 billion of the post-World War 2 (WW2) Marshall Plan in today's terms.

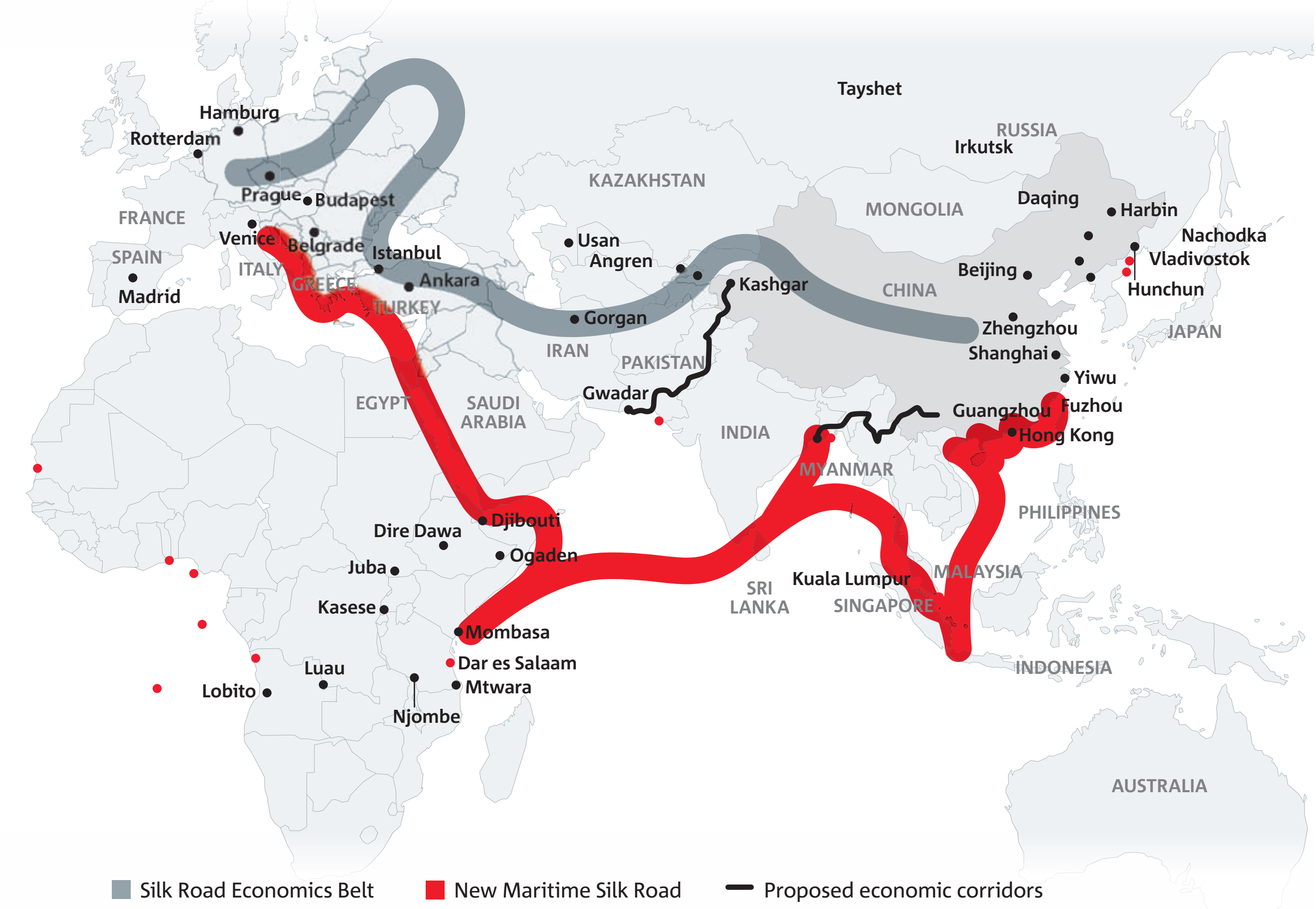
Certainly, the BRI could bring a swath of infrastructure expertise and investment funds to countries historically starved of both and whose economies remain hamstrung by supply-side bottlenecks. From Southeast Asia to Africa and Central Asia to Eastern Europe; roads, railways, ports, airports and power supply – both fossil fuel fuelled and alternative energy; and telecommunications, the BRI could alleviate shortages in all these areas.

However, there's a flip side. The BRI has often been compared to the Marshall Plan – the US' reconstruction plan for Europe post-WW2 – but a key difference is that the BRI is not funded by foreign aid or foreign direct investment but loan financing. This contains risks for both the lender and the borrower, especially for loans to some specific areas such as Central Asia and Africa.

Nevertheless, the BRI is likely to have an enduring impact for the immediate region, especially Southeast Asia and Australia. Beyond the likely increase in regional trade, the potential for increased usage of the RMB for both transactions and reserve allocations is fairly substantial. The potential for Australia to participate in a range of BRI projects is very meaningful, and this could lead to increased access to mainland markets.

Chart 3: Reviving the Silk Road

Announced by Chinese President Xi Jinping in 2013, the Silk Road initiative, also known as China's Belt and Road Initiative, aims to invest in infrastructure projects including railways and power grids in central, west and southern Asia, as well as Africa and Europe.

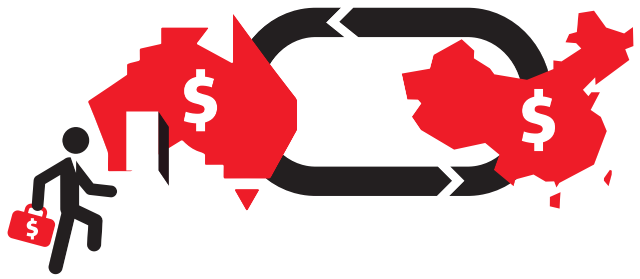


Source: Mercator Institute for China Studies; Reuters *As of December 2015

Australia as partner

Australia's engagement with the BRI is likely to be largely as a complementary services provider, rather than as a recipient of funding. The Australian Institute of International Affairs (AIIA) lists three main areas of opportunity for Australia:

1. China's investment in Australia;
2. Australia's investment in China;
3. Opportunities for Australian industries in third countries. There could be significant economic benefits to Australia through the opening up of investment opportunities.



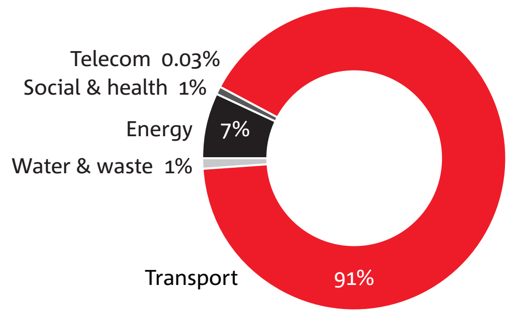
On the first item, China is also seeking to participate in the AUD 5 billion Northern Australia Infrastructure Facility, by which the Federal Government will provide concessional loans for the construction of major infrastructure like ports, roads, rail, pipelines and electricity. Businesses have been generally keen, especially the major banks, law firms, and consulting companies. The Australia China Business Council (ACBC) has been taking delegations of Northern Territories (NT) businesses to China to build ties. The NT Government is strongly supportive of the project, viewing overseas investment as vital to developing northern Australia. However, progress here remains stymied by the Federal Government's wariness of the potential geopolitical implications of the BRI. When Chinese President Xi Jinping met Prime Minister Malcolm Turnbull in April 2015, Xi had called for a linking of the BRI with the NT development plan, along with China's innovation-driven development strategy and Australian national innovation and science agenda. The Australian Federal Government has thus far declined China's offer to link NT development with the BRI and China clearly has its work cut out on easing the suspicions and discomforts regarding its intentions.

One avenue would be fostering a strong, cooperative working relationship with Australian firms on the various BRI projects. The AIIA suggests that infrastructure implementation over the long-term will require substantial skills in "sectors in which Australia has recognised global strengths, including infrastructure, energy and resources, advanced manufacturing, education and banking and finance". The Australia-China One-Belt-One-Road Initiative (ACOBORI) notes that Australia and China's trade and investment relationship is highly complementary and that collaborations between Australian and Chinese firms provides opportunities to work out mutually beneficial partnership structures to deliver on BRI projects. Participation in BRI projects also brings access to alternative capital sources and instruments like the Asian Infrastructure Investment Bank (AIIB)[1] and the Silk Road Fund[2].

The BRI project roster for Southeast Asia provides an interesting opportunity for such collaboration. The Economist Intelligence Unit (EIU) counts 130 BRI projects in Southeast Asia totalling nearly USD 250 billion in value, mostly in the area of development of transportation systems. The Asian Development Bank (ADB) in 2016 estimated that Southeast Asia needs a baseline of USD 2.8 trillion (USD 3.1 billion climate adjusted) in infrastructure spending by 2030. Much of this is needed by neighbouring Indonesia: USD 1.1 billion baseline and USD 1.2 billion climate adjusted.

It's also hoped that a good working relationship between Chinese and Australian government and firms on BRI projects will extend to greater access to mainland Chinese markets for Australian business. An ageing population in China means that demand for various medical and healthcare services will be on the rise there and Australian companies can leverage on strong bilateral relations to greater access to have the mainland market.

Chart 4: BRI in SEA mostly focused on transportation



Source: National Australia Bank, EIU

Beyond the mutual investment links and cooperation on BRI projects, there's significant scope for the increased infrastructure work to add to overall global commodity demand, something that Australia is likely to benefit from, especially if there are bilateral deals between Australia and either China or some third party beneficiary nation.

[1] The AIIB is a multilateral lender started by China in 2014 with USD 50 billion in capital for the purpose of helping fund lending for infrastructure projects, mainly in Asia. Currently with 77 national members, another 8 are expected to join by the end of 2017.

[2] The Silk Road Fund is a USD 124 billion state owned investment fund of the Chinese government, started in December 2014, to foster increased investment in BRI countries.

China stands to benefit as well

For the investment-starved developing economies along much of the BRI route, there are obvious benefits from the surge in foreign direct investment (FDI) into key sectors that will be able to boost productivity. While these have been grabbing the headlines, it should also be noted that the BRI also fits China's needs at this key juncture, when its economy is transforming from an investment-and-exports led one to one driven more by consumption, and productivity taking more of the burden rather than raw injections of capital.

The direct benefits for China from the BRI include:

1 Improved trade relations, access to raw materials and investment opportunities, and diplomatic relations with the BRI region countries. China has in the past years invested heavily in access to commodity resources.

2 A profitable avenue to export its excess capacity in industrial segments like steel, solar and construction. Many of the BRI deals consist of provision of financing to purchase services from Chinese construction or engineering firms that end up employing Chinese workers.

3 An opportunity to constructively utilise its excess savings and better deploy its FX reserves.

4 Create economic momentum for China's western and northern regions that have lagged behind the economic development of its eastern coastal regions.

Table 1: IMF requirement as share of FX reserves

	Ineffective Capital Controls	Effective Capital Controls
Fixed FX	93%	55%
Floating FX	51%	32%

Note: Using median scenario weights, the adequacy requirement is 52% of current reserves
Source: National Australia Bank, IMF

Additionally, there are also spillover benefits that fit into China's overall strategic goals:

1 Grow the role of the RMB as both an international transactions settlements medium and as an FX reserve currency.

2 Increase soft power and influence, especially in Asia.

Role for financial centres

Although well-financed and already well-developed, both the Asian financial centres of Hong Kong and Singapore are still upgrading their respective transport infrastructure systems and many of these projects have been included as part of the BRI, with Chinese firms likely to be bidding for a share of the work. After the Kuala Lumpur-Singapore high speed rail, second on the CG/LA "Strategic 100" list is the Third Runway at the Hong Kong International Airport valued at USD 8 billion.

Besides some high profile projects though, the 2 financial centres are set to play other roles in the BRI – arranging financing and helping to smooth the international interaction that will be a necessary part of the process. National People's Congress Standing Committee chairman Zhang Dejiang in May 2016 labelled Hong Kong a hub for BRI projects and the Hong Kong Monetary Authority has launched an Infrastructure Financing Facilitation Office to help raise funds for BRI projects. Apart from the obvious benefit of having proximity to mainland China, Hong Kong is also the biggest offshore RMB market and will most definitely play a key role in fund raising for BRI projects.

Not to be outdone, Singapore has signed a memorandum of understanding (MOU) with China to provide Singapore and Chinese companies investing in China and Singapore respectively, along with other companies investing in other markets under the BRI. The Monetary Authority of Singapore (MAS) is also supporting Singapore's role in drawing in infrastructure finance, recently lauding BRI bond issuance by Chinese banks in Singapore: China Construction Bank had issued USD 145 million of BRI bonds in 2016 and Bank of China issued USD 600 million in May 2017. Singapore will likely have a comparative advantage in raising capital for projects in the Southeast Asia and South Asia region.

BRI pitfalls

The best laid plans can still fall foul to a range of structural risks, which the BRI isn't short of:

1. Impediments to project completion. Many of the BRI countries, especially in Central Asia, suffer from political instability and/or ineffective bureaucracies. The USD 430 million Kara-Balta oil refinery in the Kyrgyz Republic is a key negative example. Zhongda China Petrol Company had support from the Kyrgyz government to build a plant with an output capacity of 850,000 tons by early 2015 but could only hit under 6% of the target due to an inability to source enough crude. The main difficulty was the inability to enforce contracts, but the local physical infrastructure also contributed. The Kyrgyz government also seems not to have appreciated the scope of Zhongda's difficulties.

Even when the project work proceeds smoothly, disputes can arise, as was the case with Kenya's USD 14 billion 485km Standard Gauge Railway (SGR), wherein China Road and Bridge Corporation has been accused of not meeting its commitment to source at least 40% of goods and services from local firms. There were also disputes about the tendering process and costs – the projections for the SGR were an average of USD5.6/km, compared to international norms of around USD2/km and the USD4.8/km that neighbouring Ethiopia incurred laying a more sophisticated track.

2. Exposure to risky credits and potential for defaults. Although the funding mode of largely bank or bilateral loans technically means that the profitability risks reside with the borrower, the lenders still carry the default risks. The presence of diplomacy objectives also increases the risk of moral hazard. The EIU assessed most of the borrowers to have a higher risk rating (combination of both economic and political risk) than China, especially for Central Asia and Africa. Failure to complete the projects is one source of risk for defaults but poor management could also result in insufficient revenue or economic benefits that might provoke demands for renegotiated terms.

3. Risk of entanglements with domestic politics. There has already been one example of this in Sri Lanka, where the cooperative government of Mahinda Rajapaksa was voted out of office in January 2015 and the new administration of Maithripala Sirisena proceeded to freeze major projects previously awarded to Chinese firms. One of these was the high-profile USD 1.4 billion Colombo Port City reclamation project, led by China Harbour Engineering Company (CHEC). Despite having the support of President Xi Jinping, it was not until March 2016 that CHEC was able to resume work, albeit under less favourable terms for the Chinese.

4. Potential for increased tensions with other important players. It might be worth noting that the Sri Lankan episode is suspected to have been partly instigated by India, which also seems to have had a hand in the change of government in Sri Lanka. India and China have long been regional rivals and India seems to fear the perceived growing Chinese influence in a region it probably considers its own backyard. China's close ties with long-time India rival Pakistan will also contribute to the simmering geopolitical risks in the region. Over June-August 2017, Indian and Chinese troops faced each other down in Doklam, an area contested by China and Bhutan. Such border tensions are common and could embroil regional BRI projects. Competition for projects could also impact relations with another regional rival Japan.

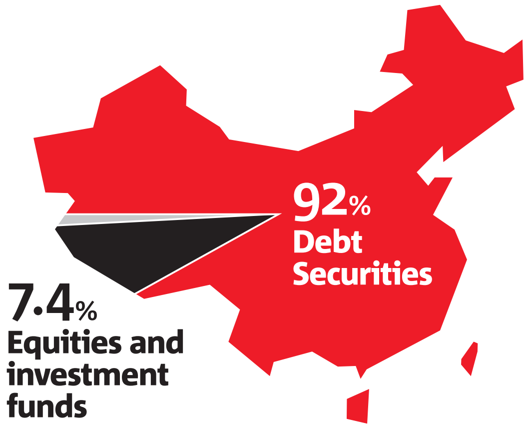
5. Territorial disputes could threaten projects. The prime example of this would be the dispute over the oil-rich Spratly Islands in the South China Sea, where China has been constructing artificial islands that are said to be able to serve as military facilities. The islands are also claimed by Malaysia, Vietnam, the Philippines and Taiwan – the first 2 are in the BRI zone.

THE BOND CONNECT PLOT THICKENS

China's Bond Connect kicked off in July 2017 and thus far, there have been encouraging signs. It's currently a pilot scheme connecting Hong Kong (HK) and China and confined to northbound access. While it's neither the first nor only avenue for foreign investors to invest in China's bond market, it's definitely a more investor friendly channel and likely to be a more efficient framework for China to deepen and broaden its fixed income market in the long run. As the scheme expands beyond current northbound investment in the near future, China is likely to see an influx of buyers for its debt as well. Several factors are seen to underpin foreign investors' appetite and these include:

1. Potential inclusion of Chinese bonds into global bond indexes
2. Currently only a small proportion of foreign holdings of Chinese debt relative to total size of Chinese market
3. RMB stability

Demand from foreign central banks is the main focus of our analysis and we expect this to increase steadily over the medium term. Given the sheer size of China's domestic bond market, the impact on China's financial markets can be very meaningful in the medium term. The total onshore bonds held by foreign institutions stood at RMB 841.5 billion at the end of July, equivalent to only 1.77% of the interbank market, registered at the China Central Depository & Clearing Co., Ltd. (CCDC), but already 8% up from RMB 778.85 billion at the end of 2016. The bulk of these investors are foreign central banks. According to SAFE data, as of end-2016, foreign central banks held RMB 563.5 billion worth of RMB assets – 92% in debt securities, with equities and investment funds making up 7.4%.

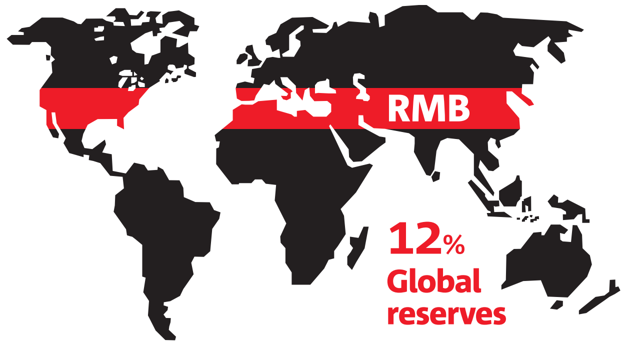


Trillion dollar question: How much inflows can be expected?

The early success of the HK-China Bond Connect points to an encouraging future. In the first month following the launch on 3 July 2017, foreign investors bought a net RMB 37.8 billion worth of Chinese bonds, accounting for more than half of the total foreign investments in the first seven months of this year (RMB 62.6 billion).

However, the focus of interest has been on short-term papers with tenors less than one year, such as commercial papers, usually in the names of super short-term bills or short-term bills, and certificates of deposits, according to the Shanghai Clearing House.

The potential bond market inflows can be estimated based on regional central banks' FX reserves (assuming that they will increase the RMB component in their coffers given that the currency is now a member of the SDR basket), and foreign institutional investors' potential demand.



Modelling done by the Asian Development Bank Institute (ADBI) found that using only quantitative economic predictors, the projected RMB share could go as high as 12% of global reserves. Adding institutional and market measures reduced the predicted share to around 2%, which the ADBI felt was "more realistic". However, we would caution that this was based on 2011 data and published in 2014; since then, China has made huge strides towards an environment that the ADBI recommended. From 5 models that the ADBI had used, we selected one that reasonably represents current conditions, and another one that would be appropriate after full capital liberalisation (targeted for 2020). The respective RMB shares projected by these two models are 6.8% and 10%. In the near term, we could be looking at inflows north of USD 1 trillion but in the medium term, inflows of more than USD 2.5 trillion would not be out of the question.

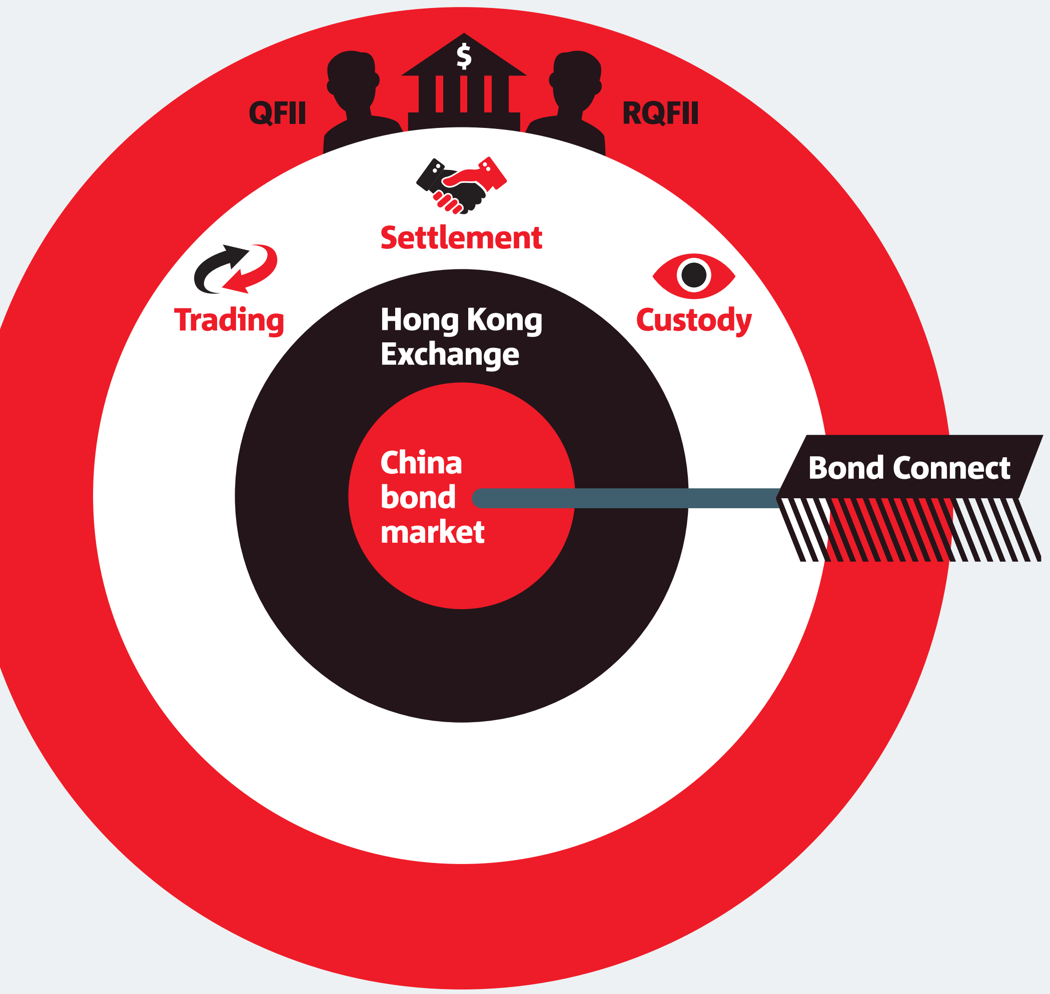
What is the Bond Connect?

The Bond Connect is a scheme that entails mutual market access to China and overseas bond markets, in activities involving trading, custody and settlement. On 3 July 2017, China launched the HK-China Bond Connect Programme and in the initial phase, only allows northbound trading.

This marks the fourth bond market programme that enables cross-border trading following the China Interbank Bond Market (CIBM) direct access scheme, the Qualified Foreign Institutional Investor (QFII) and the Renminbi Qualified Foreign Institutional Investor (RQFII) schemes.

There's no quota for northbound investment and southbound trading will start at a later date. Eligible investors are mainly institutions, such as banks, insurance companies, brokerages and asset management firms.

The establishment of the Bond Connect replaces the previous mode of access whereby foreign investors had to go through the lengthy process of opening a QFII account, RMB quotas application and then finding a clearing agent with international settlement capabilities. With the Bond Connect, foreign investors can trade directly in China's bond market through the Hong Kong Exchange.



Prominence in trade and cross border capital flows

Although still fairly rare, use of the RMB in cross border flows has grown quickly in recent years. It made up 4% of global foreign exchange trading last year, and 1.9% of global payments in February, according to official data. Growing RMB cross-border flows means that FX reserve managers will need to match that in the distribution of the reserves that they hold. This then in turn generates demand for yield bearing RMB assets.

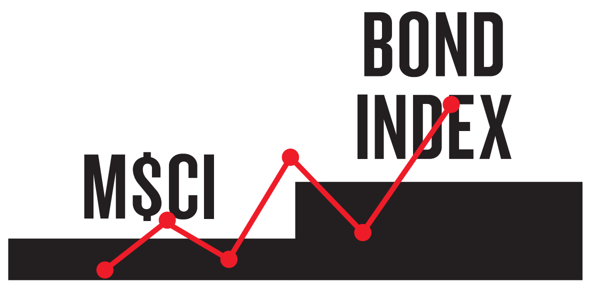
As of March 2015, 62.9% of global central bank reserves, or USD 3.826 trillion, were in U.S. dollars. Euro reserves, worth USD 1.351 trillion, represented 22.2% of the total. The Japanese Yen took a 3.9% share with USD 241.2 billion held by central banks, and USD 116.2 billion worth of Canadian dollars were held by central banks.

Key success factors

The Bond Connect scheme eliminates most of the impediments to investing in China's bond market that have previously been responsible for the low foreign participation. The China Inter-Bank Market (CIBM) was relatively closed to foreign investors prior to 2015. Back then, investing in China's debt market required application for a Qualified Foreign Institutional Investors (QFII) license. Even then, QFIIs were subjected to investment quotas and could only invest in exchange traded bonds. The approval process for participating in the market was lengthy and complex. Furthermore, foreign investors were more interested in A- and H-shares trading in China and Hong Kong, due to the large spreads between the two indexes. Low demand for QFII and RQFII products was reflected in the low utilisation rate of the allocated quota for QFIIs and RQFIIs. The total investment quota of QFIIs allotted as of the end of August 2016 was just USD 81.5 billion, little more than half the USD 150 billio in July 2013. The RMB's fortunes, or misfortunes, was another hurdle. The RMB's appreciating trend ended in 2014 and USD/CNY climbed from 6.05 to nearly 7.0 in late 2016.

In addition, the Chinese financial authorities have shown greater commitment to the success of Bond Connect. To facilitate the acclimation to the vagaries of Bond Connect, the authorities have encouraged state linked entities to issue bonds/bills specifically for Bond Connect. Among others, policy lenders Agricultural Development Bank of China and China Development Bank, held their first ever public tenders simultaneously to both onshore and offshore investors on the launch day of the scheme. The two were followed by a long list of state-owned enterprises such as Huaneng, Guodian, Chalco, China Unicom and Three Gorges, to issue Bond Connect short-term bills. More recently, the issuer base has expanded to include local government linked enterprises such as Luzhou Laojian.

After the admission of China's A-shares into the MSCI Emerging Markets Index, the conviction for Chinese bonds to be included in several global bond indexes rose perceivably. The Bond Connect may be a reinforcing factor and in return, the recognition as a global player will make Chinese debt more attractive to foreign investors. While the MSCI Emerging Markets Index is tracked by USD 1.6 trillion worth of funds, industry estimates place the three major bond indexes combined in the vicinity of USD 4 trillion. These are the JPMorgan's Government Bond Index, Barclays Global Aggregate Index and Citibank's World Government Bond Index.



In fact, there has been some notable progress towards including China into some bond indexes. In March 2017, Citigroup decided to include onshore Chinese bonds in its three government bond indexes—the Emerging Markets Government Bond Index, the Asian Government Bond Index, and the Asia Pacific Government Bond Index. In addition, Bloomberg has launched two fixed income indexes with RMB-denominated Chinese bonds. Initial estimates were that inflows into these bond indexes once Chinese bonds get included could exceed USD 200 billion.

The Bond Connect plays an integral part in the RMB internationalisation process. Combined with RMB stability, the availability and accessibility of yield bearing RMB-denominated assets is the next step forward for the currency to be recognised further as an international currency, after its entry into the IMF SDR basket.

Sovereign ratings downgrade unlikely to be an impediment

On 22 September, S&P downgraded China's long-term sovereign rating from AA- to A+, bringing it in line with Moody's downgrade from Aa3 to A1 in May 2017. By and large, the main concerns were similar to what Moody's had listed. These were namely that loan growth is still continuing at too strong a pace, and that Local Government Financing Vehicle (LGFV) poses concern.

The Chinese government disputes this reading, essentially claiming that S&P has glossed over important nuances. The market seems to agree with the government, barely reacting to the downgrade.

One reason for this is that the downgrade merely moves China to the fifth of the 11-rung Investment Grade block.

We concur with the view that the downgrades will not be a big impediment to the Bond Connect, nor will it raise funding costs materially as China's bond yields are already the highest among the other A1 graded debt. China's A1/A+ rating is shared with Japan (10Y JGB 0.021%), Israel (10Y yield 1.72%), Saudi Arabia (10Y USD bond 3.5%).

Market commentary has become somewhat more positive recently as the deleveraging efforts have started to look more authentic and the government is appearing to be quite disinclined to bail out borrowers. Foreign investors are unlikely to be spooked by the downgrade since the issues raised have been around for some time and the general opinion is that the government is on the right path, even if proceeding down it rather gingerly.

Relevance for Australia

The RBA has invested a portion of Australia's foreign exchange reserves in RMB since 2013. The plans revealed then were to invest around 5% of its FX reserves in China. The number looked conservative relative to the extent of trade relation between Australia and China then, and probably reflected the hurdle from the lack of capital account liberalisation. However, the Bond Connect is the game changer and now allows an acceleration of reserve diversification into RMB assets.

Perhaps the bigger question – relevant for the AUD – is whether increased demand for RMB and RMB assets by reserve managers could see reduced demand for AUD as a reserve asset? It is often suggested that the AUD may be being held by reserve managers in part as a 'China proxy' given the strong trade links between Australia and China. We are highly sceptical about this.

The increased use of AUD as a reserve asset since the Global Financial Crisis has been part of a generalised desire to diversify away from the USD (and the EUR during the various Eurozone crises since 2011). The fact that holdings of CAD have risen by as much as for AUD (in both case to just under 2% of holdings) and given the more tenuous direct trade links between Canada and China, suggest that the 'China proxy' argument for AUD holdings is largely illusory.

As of Q1 2017, reserve managers who divulge their allocations to the IMF hold on average 1.84% in AUD and 1.93% in CAD (in both cases just over 0.1% higher than a year earlier). There's no evidence here then the AUD enjoys favouritism over CAD, and as such little or no reason to think global reserve managers will materially reduce AUD holdings in conjunction with any diversification towards RMB, beyond any generalised diversification towards RMB and away from other currencies over the medium/longer term.

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