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RMB Roadmap 2017

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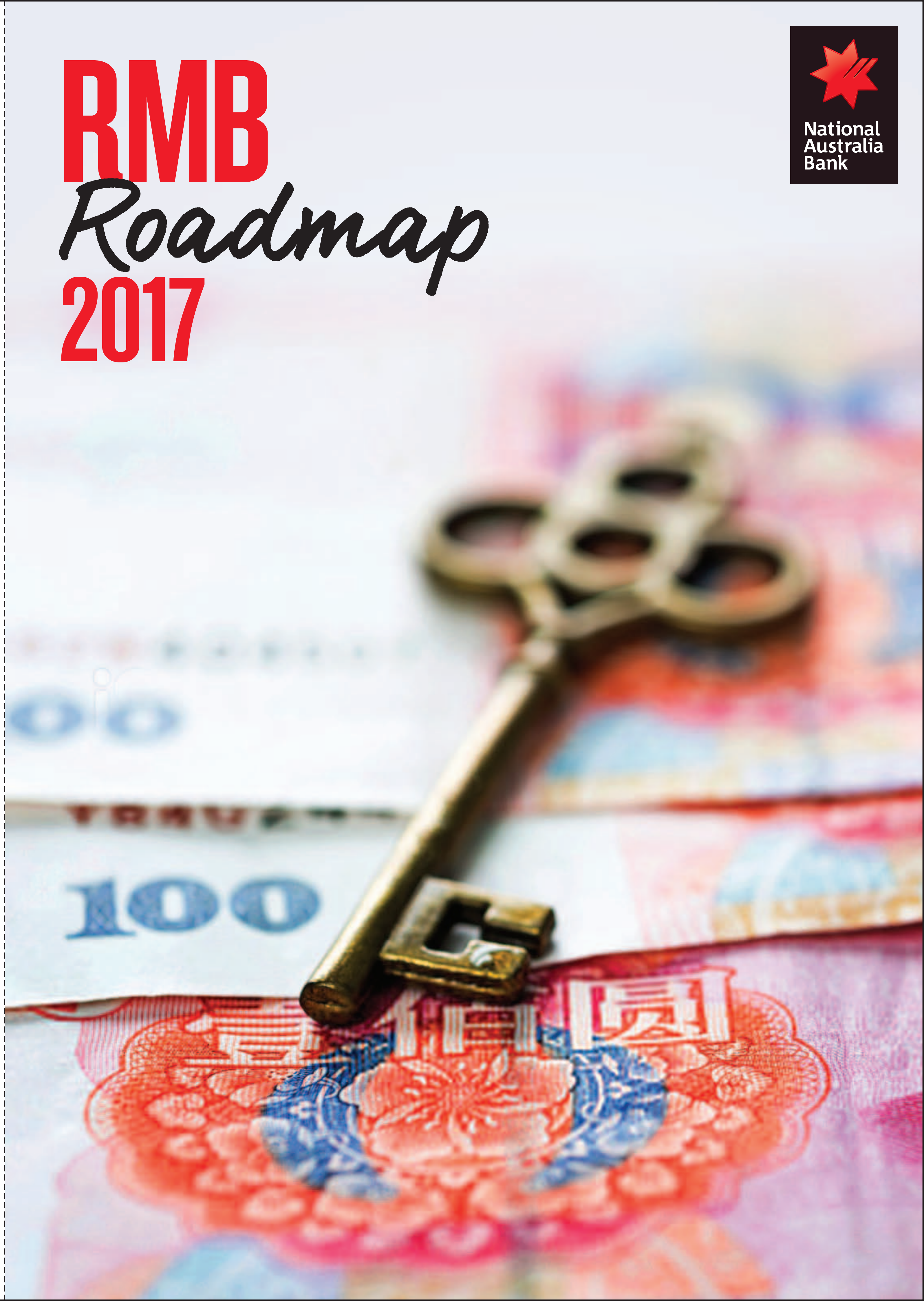

CONTENTS

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Christy Tan is the Head of Markets Strategy and Research for Asia within the Fixed Income Currencies & Commodities, Corporate & Institutional Banking, based in Hong Kong. Since joining National Australia Bank (NAB), Christy has built the Asia research platform and is an active contributor to NAB's expansion drive into China and the region. Christy spearheaded Asia research and publication including the flagship report Essential Asia as well as other thematic reports involving Asia, China and RMB. Consequently, NAB has also climbed up the ranks in FX forecasts and was ranked top 3 in Asia FX forecasts by Bloomberg for three consecutive quarters starting third quarter of 2014. Christy joined NAB in July 2014 from Bank of America Merrill Lynch, where she held the Senior Director role within the Asia fixed income and currencies team. In the nine years with BAML, Christy was based in Singapore and has developed strong clientele relationships including key corporates and MNCs, as well as financial institutions. Christy has a Bachelor of Science with an Economics major from the National University of Singapore and is currently pursuing MBA studies with Manchester Business School.

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Julian Wee is the Senior Markets Strategist within the Asia research team and is responsible for Southeast Asia (plus India) FX strategy coverage in NAB. Julian has close to 15 years' experience in macro research and strategy for Asian economies and he joins NAB from BSI Bank, where he supported the head office with in-depth coverage of Asia's economics and politics as well as portfolio strategy. Prior to BSI, Julian spent a total of 8 years at the independent research house IDEAglobal, covering the macroeconomics and politics of most Asia ex-Japan economies and a year at Dow Jones Newswires producing expert commentary on Asia ex-Japan's FX markets. Julian has a Masters in Public Policy from the Lee Kuan Yew School of Public Policy (National University of Singapore), which included a semester at the School of International and Public Affairs at Columbia University. Julian also has Bachelor of Arts, with a major in Economics, from the National University of Singapore.

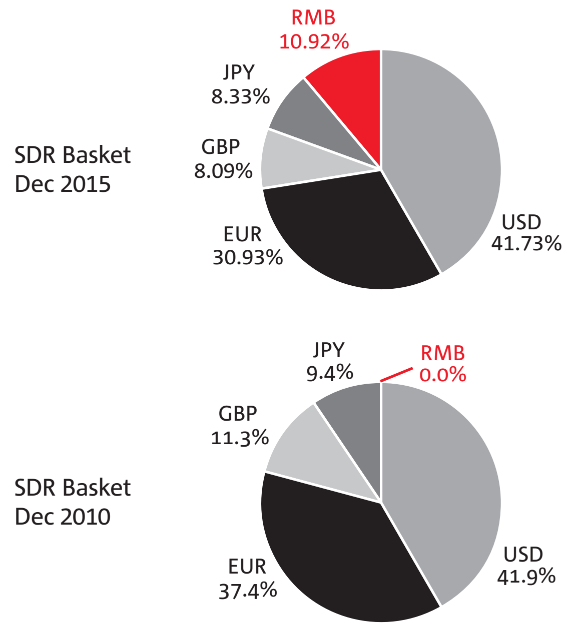
A GIANT CUB IN THE CLUB

After a 5-year long trudge through a host of liberalization measures affecting many aspects of the RMB's management, China was rewarded with reserve currency status for its currency. The RMB was allocated 11% of the IMF's Special Drawing Rights (SDR) basket, the third largest share behind the USD and the EUR.

The inclusion was announced at the end of November 2015, 10 months ahead of the formal inclusion to facilitate the "smooth functioning of SDR-related operations" by allowing users to "adjust to a potentially changed basket composition". The full impact of the addition to the SDR though is not likely to fully manifest itself immediately given that the liberalization of both the capital account and the domestic financial markets is likely to continue for some time. About 50 countries have taken the RMB as part of their foreign exchange reserves, but only 1.1% of total foreign assets held by monetary authorities around the world were denominated in RMB as the end of 2014, according to the IMF. Singapore has announced its commitment to add RMB-denominated assets into its official foreign reserves from June 2016 onwards.

The immediate aftermath of the decision probably did not go as the authorities might have liked, with volatility in the USD/CNY and USD/CNH markets increasing significantly especially in the months of December 2015 and January 2016. This volatility was also accompanied by a sharp decline in FX reserves and prompted a somewhat curious examination of whether or not China had enough reserves.

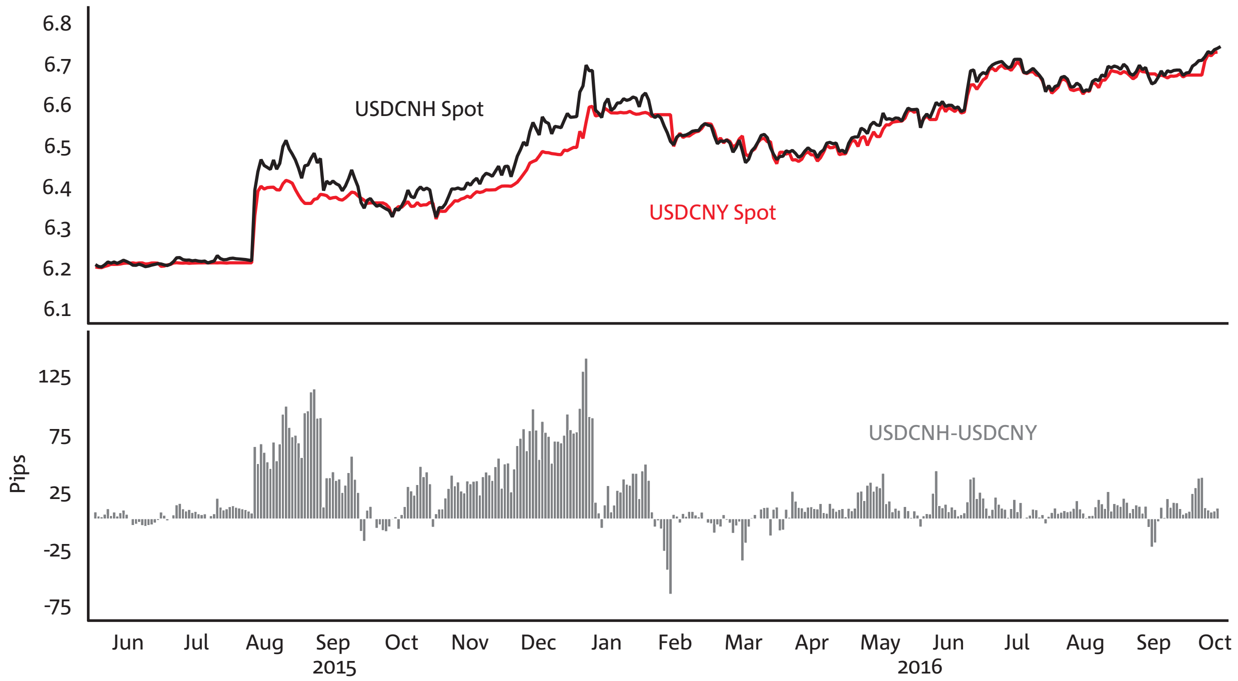
GRAPH 1. THE SDR BASKET HAS A NEW MEMBER



Source: National Australia Bank, IMF

Over the medium term, the use of the RMB as both a trade settlement currency as well as a reserve currency remains a priority. This suggests the scope for an eventual "strong RMB policy". In the meantime though, the authorities seem to have settled on an FX regime that swaps the tight bilateral link with the USD with a looser link between the RMB and USD as measured against a basket of currencies.

GRAPH 2. CNY-CNH GAP CONTAINED SINCE FEB 2016



Source: National Australia Bank, Macrobond

FX RESERVES – JUST HOW MUCH IS ENOUGH?

In response to the sudden surge of outflows, China enacted a slew of measures that defied a one-size-fits-all description. Broadly speaking, **the measures conformed to an attempt to filter out speculative capital flows while still allowing real economic flows, apparently defined as flows related to trade or direct investment, regardless of the direction of the flow**.

Also important is the fact that the IMF is also comfortable with China's efforts to increase the effectiveness of existing capital controls. The IMF's recent research points to the effectiveness of capital controls as being a key determinant for reserve adequacy, along with the currency regime, specifically how the currency is fixed.

In its April 2015 Assessing Reserve Adequacy (ARA) report, the IMF refined the metrics first outlined in 2013 to take note of the impact of capital controls or "capital flow management measures" (CFMs). The IMF has emphasized that CFMs do not always constitute an appropriate response to external pressures nor are they a substitute for reserves. The IMF also stressed that CFMs are not a substitute for necessary macroeconomic adjustment and if used, "should typically seek to be transparent, temporary, and non-discriminatory". The refined metric in 2015 takes into account the impact that CFMs might have on the amount of potential capital flight from residents, by assigning different weights for the broad money component.

The matrix of weights provided by the IMF yields the results listed in Table 2. What is clear from the table is that letting the currency float, and having effective capital controls, both contribute very materially to reducing the amount of precautionary FX reserves needed. This at least partially explains the Chinese authorities' focus on tightening the enforcement of existing capital controls as a means of dealing with the sudden surge in outflows.

TABLE 1. FX RESERVES AS A PERCENTAGE OF IMF REQUIREMENT

	Ineffective Capital Controls	Effective Capital Controls
Fixed FX	115%	191%
Floating FX	206%	321%

Note: The IMF considers reserves at 100%-150% of required to be adequate.
Source: National Australia Bank, IMF

The IMF methodology suggests that even in the most onerous situation of ineffective capital controls coupled with a fixed FX regime, China does possess more than what would likely be needed. A scenario based on the median requirements would place the current amount of FX reserves at 197% of what would be required, comfortably beyond adequate.

The four components that the IMF considered key to potential balance of payments drain are:

1. Export income to reflect the potential loss from a drop in external demand or a terms-of-trade shock.
2. Broad money to capture potential residents' capital flight through the liquidation of their highly liquid domestic assets.
3. Short-term debt to reflect debt rollover risks.
4. Other Liabilities (both debt and equities) to reflect other portfolio outflows.

Adequacy depends on controls and FX regime

What is clear from the IMF's methodology is that letting the currency float, and having effective capital controls, both contribute very materially to reducing the amount of precautionary FX reserves needed.

This probably explains the Chinese authorities' focus on tightening the enforcement of existing capital controls, in response to the surge of corporate pre-payments over the months of December 2015 and January 2016. However, the authorities continue to distinguish hot money flows from trade and direct investment flows. While on the one hand, there is a growing push for increasing the usage of the RMB for investment and trade flows; on the other hand though, there is continued caution over hot money flows masquerading as real flows. **It should also be noted that this ambivalence to hot money flows does not seem to encompass QFII or RQFII flows, given that both were further relaxed in February 2016.**

Delicate balance maintained with capital controls

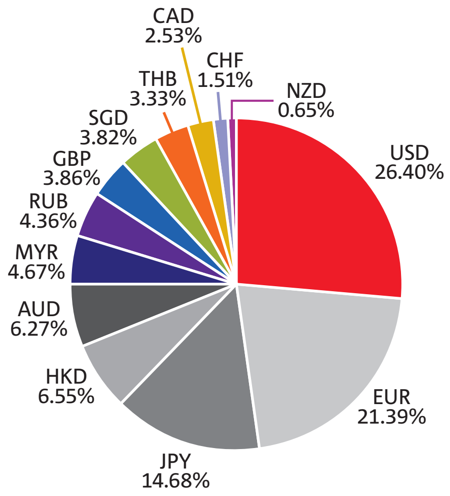
- The People's Bank of China (PBoC) reportedly suspended some foreign banks in China from conducting certain foreign exchange transactions designed to arbitrage the gap between the onshore and offshore RMB exchange rates.
- The State Administration of Foreign Exchange (SAFE) has barred lenders from helping companies to buy FX to repay debt ahead of schedule if that was not required by their contracts with creditors. Prior to this there were no restrictions on the timing of FX purchases. SAFE later clarified that this does not apply to Overseas Direct Investment (ODI). SAFE also required companies that need USD 50 million or more to plan these purchases with SAFE and their banks.
- SAFE has tightened restrictions on purchases of insurance products overseas, which was being used to illicitly bring money out of the country. Purchases of insurance products using UnionPay debit and credit cards will be capped at USD 5,000 per transaction effective 4 February 2016. There was no limit previously.
- The PBoC has suspended new applications for the Renminbi Qualified Domestic Institutional Investor (RQDII) investment scheme. Market players say some of the RQDII products have been used not only to buy RMB-denominated products, but also USD bonds, options and other structured products, which has raised concerns about the risks related to these products. Allegedly, domestic investors only aggressively entered overseas markets after the central bank weakened its currency on 11 August 2015.
- SAFE instructed banks in Shenzhen to limit USD buying by individual and corporate clients, according to news reports. The official Shanghai Securities News cited client managers at banks in Shenzhen China as saying that demand for USD and HKD had increased sharply since the start of 2016. Chinese residents are permitted to buy up to USD 50,000 annually, with the quota resetting at the beginning of the calendar year.

THE BASKET MAKES IT LESS OF A BASKET CASE

The key policy change that emerged in the aftermath of the RMB's entry into the SDR basket is that the RMB will now be managed against a basket of currencies. The basket was constructed according to weights released by the China Foreign Exchange Trading System (CFETS), an agency under the PBoC, that provides, amongst other things, systems for FX trading, RMB lending, and exchange rate derivatives trading.

The CFETS basket consists of 13 currencies, all but the THB enjoying direct trading with the CNY. The basket is heavily skewed towards the G3 currencies which, together with the USD-pegged HKD, make up 69% of the basket. The AUD, with a weight of 6.3%, is the fifth largest component and reflects the significance of the bilateral trade between China and Australia.

GRAPH 3. CFETS RMB INDEX



Source: National Australia Bank, CEFTS

BUT STILL IN THE SHADOW OF THE USD

Although the move to use the CFETS RMB Index (RMBX) ostensibly loosens the link between the RMB and the USD, the fact of the matter is that the USD and the HKD make up 33% of the basket and there appears to be clear signs that at least until the middle of June 2016, the Chinese authorities have been managing the RMBX in line with the DXY, an EUR-centric USD index. While this has indeed led to more "two-way flexibility" in both the USD/CNY spot and fixing, the tethering of the RMBX to the DXY reflects the fact the shift towards a truer float will only happen gradually via a staggered introduction of a greater degree of market determination.

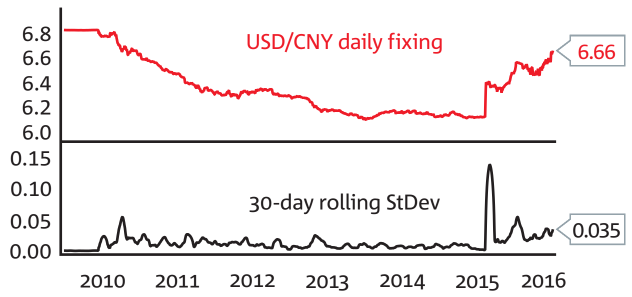
NATIONAL AUSTRALIA BANK *RMB Roadmap 2017*

In early July 2016, the CFETS provided an explanation for the apparent deviation from the DXY in June, saying that the depreciation of the RMBX in June was due to strong FX demand and "Brexit", suggesting that the extent of the downside, if not the entire deviation from the DXY, might not be permanent. **The CFETS also committed to continuing the "two-way moves" in the USD/CNY "based on market supply and demand" while maintaining stability against the basket of currencies.**

GRAPH 4. RMB INDEX MANAGED IN LINE WITH THE DXY INDEX

Source: National Australia Bank, Macrobond

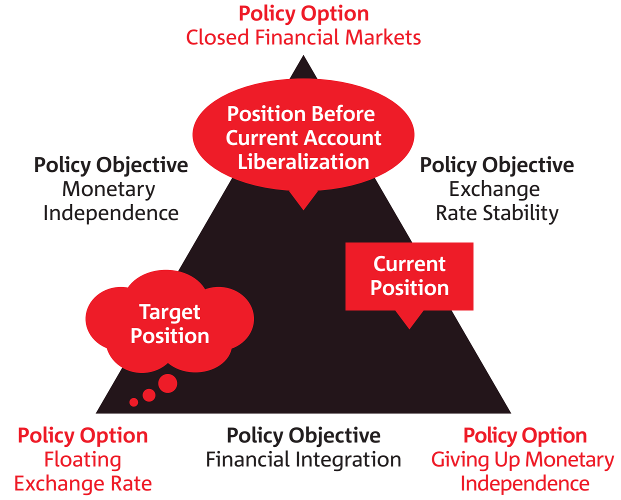
GRAPH 5. USD/CNY FIXING MORE VOLATILE SINCE AUG 2015



Source: National Australia Bank, Macrobond

This is in line with the IMF's 2015 call on Chinese authorities to move to an "effectively floating exchange rate" within 2-3 years. The IMF expects that this will help with the economy's rebalancing towards consumption. Continued liberalization of the financial account is necessary for the deepening of financial markets but without liberalizing the currency, as the Impossible Trilemma dictates that China will lose monetary policy independence, something that a large economy like China really cannot afford. A more freely floating currency is therefore vital to the China's continued evolution towards a market economy.

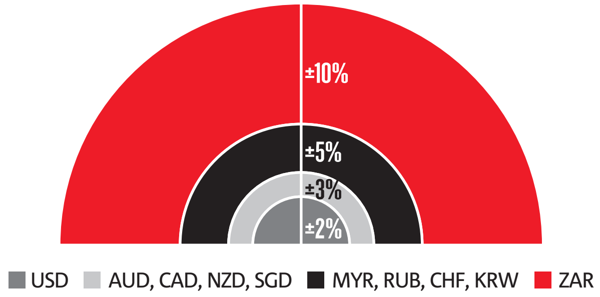
GRAPH 6. CHINA'S EVOLVING TRILEMMA



Source: National Australia Bank, IMF

While the RMB management regime is constantly evolving, the basket against which the RMB is valued might also continue to evolve. For the current basket, the THB is the only one for which there is no direct trading. In June 2016, China allowed direct RMB trading with the KRW and ZAR and there is growing expectation that both will be added to the basket at some point. Going forward, more bilateral currency swap deals and expansion in RMB settlements are expected to evolve around countries included in the government's "One-Belt, One-Road" initiative. At the moment, the various currencies that have direct trading with the CNY are restricted to daily trading ranges of varying sizes. Beyond the fact that the USD has by far the largest effective weight in the CFETS basket, the narrowest trading range for the USD/CNY also means that the USD is still very much an anchor for the CNY.

GRAPH 7. TRADING RANGES FOR DIRECT TRADING FX



Source: National Australia Bank, CEFTS

While this might be the case, it is probably more accurate to characterize this as a gradual movement away from being tied to the USD. **The timing for a full liberalization will probably coincide with the government's goal for a full opening of the capital account by 2020.**

CAPITAL MARKETS AND OFFSHORE ACCESS

In the next few years, the pace of changes in the RMB management regime will probably slow down somewhat as the authorities shift their focus to addressing the issues of latent non-performing loans and increasing market access to onshore capital debt and equity markets. In February 2016, the authorities relaxed the rules restricting QFII flows in and out of the country and also broadened access to the Chinese Interbank Bond Market (CIBM). The timing of the moves were striking in the fact that they came just after a massive surge of outflows from corporates prepaying their foreign loans, followed by a slew of restrictions aimed at curbing similar events in the future.

The change in the QFII rules, listed in the accompanying table, were aimed at increasing the ease with which quotas can be acquired and utlized, while also incentivizing a more expedient utilization of these quotas. It is noteworthy that the changes mostly facilitated both inflows and outflows. This seems to be a meaningful recognition on the part of the authorities of the need to allow a greater degree of two-way flows if the onshore debt and equity markets are to attract a greater amount of global institutional interest. An increase in foreign participation would in turn increase the global demand for the RMB.

In addition to the change in QFII rules, the PBoC also widened the access that foreign institutional investors had to the CIBM. The very gradual opening up of the CIBM to foreign investors essentially started with a pilot scheme in August 2010, with Hong Kong subsidiaries of Chinese fund management firms granted RQFII status in December 2011, and in July 2015 foreign monetary authorities and sovereign wealth funds were exempted from needing PBoC approval and quota restrictions. The 2016 liberalization crucially extends many of these participation rights to most types of foreign institutional investors and makes the process of participating in the CIBM much easier.

TABLE 2. GREATER QFII ACCESS

Aspect	New procedure	Old procedure
Quota size	1. QFIIs can apply for a "basic quota" based on their AUM, within a range of USD 20 million and USD 5 billion. 2. Foreign sovereign wealth funds, central banks and monetary authorities are exempt from this cap; their basic quotas are assigned based on their investment needs. 3. A QFII has to apply to SAFE for a larger basic quota.	1. QFII quotas are approved upon application on a case-by-case basis.
Funds inflows/ outflows	1. Upon being assigned a quota, QFII has a year to bring in funds before SAFE has the right to rescind the unused quota. 2. Open ended QFII can bring funds in or out on a daily basis.	1. QFII had only 6 months to utilise quota or risk having it withdrawn. 2. Open ended QFII only allowed weekly injections/withdrawals
Lock-up period	1. QFII principal lock-up reduced to 3 months.	1. QFII principal lock-up was usually 12 months

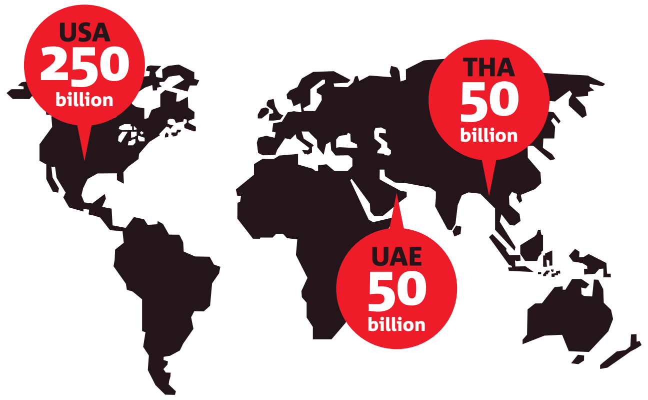
Source: SAFE

TABLE 3. CHANGES IN QFII RULES

Aspect	New rules	Old rules
Further Expanded Scope of Foreign Institutional Investors	Most types of foreign institutional investors now permitted, including "commercial banks, insurance companies, securities firms, fund management companies, pension funds, charity funds, endowment funds" and "other mid-term or long-term institution investors recognized by PBoC".	Previously only a few specified types of foreign institutional investors, mainly state-backed banks and funds, international organizations, QFIIs and RQFIIs were permitted.
Removal of Quota Restriction	Exempts all the Foreign Institutional Financial Investors permitted to invest in the CIBM from the restriction of a quota.	Previously only foreign central banks, monetary authorities, international financial organizations and sovereign wealth funds had this privilege.
Filing Rep laces Prior Approval	Foreign Institutional Financial Investors may start investing once they have lodged an investment filing form with PBoC, either directly or through an onshore settlement agent.	Applications to invest in the CIBM on a case-by-case basis. Only foreign central banks, monetary authorities and other entities were exempt.
Lowered Qualification Requirements; Simplified Procedures	Foreign Institutional Financial Investors do not have to apply to PBoC for eligibility to invest in CIBM. Review of eligibility delegated to the settlement agent.	Previously, a Foreign Institutional Financial Investor was required to: (i) be duly incorporated; (ii) have sound corporate governance, internal controls and legal compliance records; (iii) have legitimate sources of funds; and (iv) have the capacity to identify and bear the risks of invest

Source: People's Bank of China, Bloomberg News

GRAPH 8. RECENT RMB CLEARING CENTRES



Source: National Australia Bank

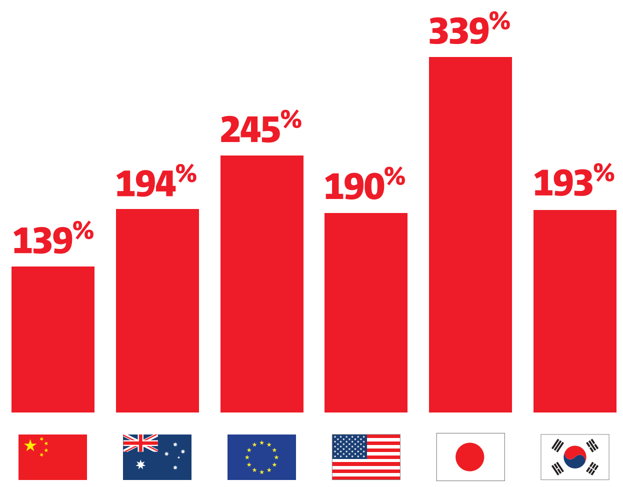
Although not likely to be the main thrust anymore, the RQFII system could still be broadened. Since admission to the IMF SDR basket, 3 more offshore RMB clearing centers have been added to the list: UAE, Thailand, and the USA, with quotas of RMB 50, 50, and 250 billion respectively. The US' joining of the scheme is a significant addition to the program and the US' quota is the largest after Hong Kong's RMB 270 billion. Going forward, more clearing centers and/or quota increases are possible, especially if the addition of onshore debt and equity markets are added to global indices.

CHINA'S ECONOMIC EVOLUTION REQUIRES CAPITAL MARKET DEEPENING

China's spectacular growth over the last 4 decades has not been matched by an increase in the size or depth of domestic bond and equity markets. The size of China's bond and equity markets stand at around 140% of GDP as of 2015. These are fairly small compared to over 190% each in the US.

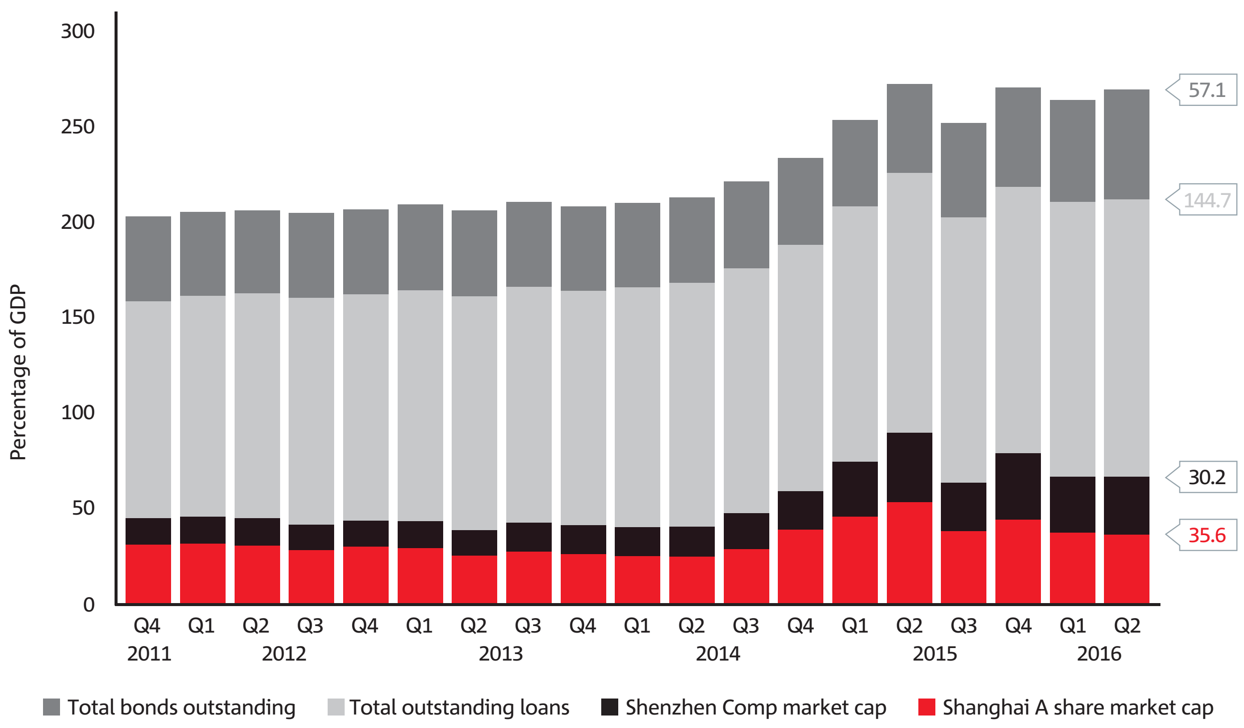
The economy remains overly dependent on bank loans as the main transmission mechanism for channelling savings into investment. Credit-to-GDP is a relatively high 250% despite the loans-to-deposits ratio being at a rather low 66%. The brief burst of trust loans growth attests to a sizable segment of the economy – namely Small and Medium Enterprises (SMEs) and the agricultural sector – that remains starved of credit despite banks being flushed with deposits.

GRAPH 9. EQUITY PLUS BOND MARKET CAPS AS SHARE OF 2015 GDP



Source: National Australia Bank, CEIC

GRAPH 10. CHINA'S INVESTMENT VIA VARIOUS CHANNELS



Source: National Australia Bank, Macrobond

There are signs that this is constraining the economy's ability to match savers to the right borrowers. Banks have traditionally looked to the government's industrial policy to provide guidance for which State Owned Enterprises (SOEs) to lend to. This, along with the overly aggressive monetary easing after the Global Financial Crisis (GFC), has contributed to a significant amount of excess capacity amost SOEs while leaving the more productive private enterprises and new economy sectors under-invested. Broadening access to deeper capital markets should help better redistribute credit throughout the economy while also redistributing the burden away from the banking sector.

The pursuit of affirmation

Beyond the admission of the RMB to the IMF's SDR basket, the authorities are also looking to get the local equity and bond markets included into the influential global indices, the MSCI and the J.P. Morgan EM Global Bond Index.

June 2016 saw MSCI once again disappoint China by delaying the inclusion of A shares in the MSCI Emerging Markets Index. The inclusion is generally considered to be more an issue of 'when' rather than 'if'; inclusion could see a sizable inflow of funds as global index funds and asset managers add A shares to their portfolios. MSCI's Emerging Market Index is tracked by portfolio managers with some USD 1.5 trillion in assets. In the meantime though, MSCI listed 3 impediments to inclusion:

1. Enhanced regulations on trading suspension: investors remained unconvinced about China's pledge to eradicate arbitrary and extended halts to stock trading.
2. QFII quota allocation and capital mobility restrictions: the monthly repatriation limit of 20% is an issue for investors facing redemptions.
3. Restrictions on launching financial products: pre-approval required from local exchanges for any financial product to be launched.

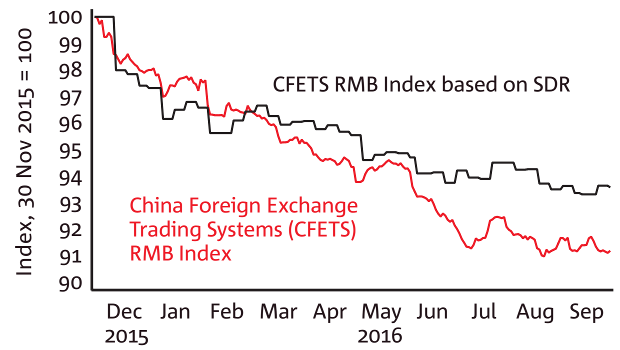
Another major potential source of affirmation resides slightly further in the background: the addition of onshore bond markets to the J.P Morgan Emerging Market Bond Indices. As of November 2015, foreign ownership in China's onshore bond markets amounted to a mere 1.6% compared to 30%-40% for countries like Malaysia, Indonesia and Mexico. The broadening of foreign institutional access to the CIBM is a major step towards satisfying the inclusion rules but J.P. Morgan has said that it is awaiting clarifications on procedural details, like the required holding period for foreign currencies and the monthly repatriation limits.

These two inclusions are quite crucial not just to deepen onshore financial markets but also to improve the monetary transmission mechanism from an over-reliance on bank credit to a greater use of capital markets to channel savings to borrowers. As such, the Chinese authorities do have substantial incentive to make the conditions sufficiently palatable for foreign institutional investors, albeit somewhat cautiously.

Bond market developments amid RMB internationalization

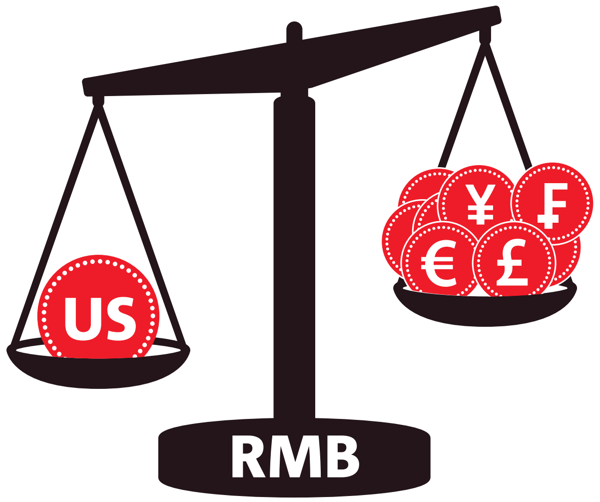
In December 2015, when the CFETS started releasing the index of the RMB's value against a trade-weighted basket, it also started releasing the value of the RMB against the SDR basket. According to the CFETS, the SDR basket is based on the relative weights in SDR currency basket.

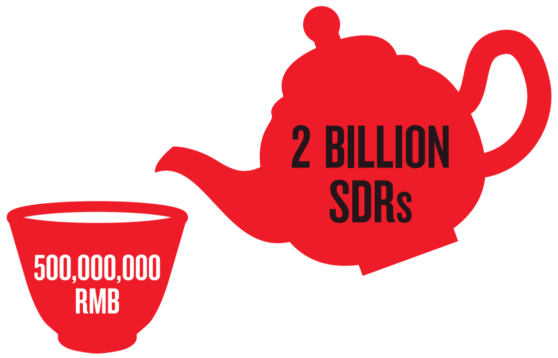
GRAPH 11. RMB AGAINST THE CFETS AND SDR BASKETS



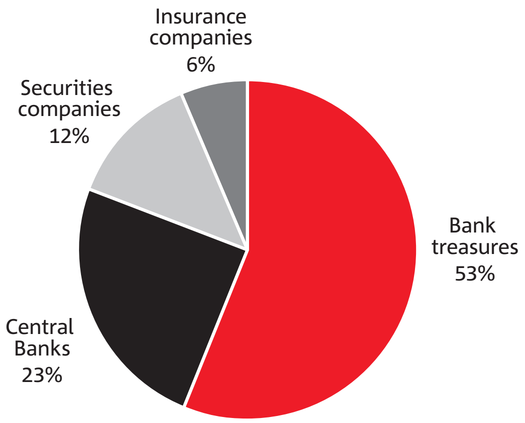
Source: National Australia Bank, CFETS, Macrobond

In the run-up to the RMB's official entry into the SDR basket on 1 October, 2016, the World Bank issued SDR 500 million (roughly equivalent to USD 700 million) worth of SDR denominated bonds in China. These bonds have been dubbed "Mulan" bonds. This tranche had a maturity of 3 years and paid a coupon of 0.49% per annum; all payments were to be made in RMB. The bonds were issued under the World Bank's new SDR Denominated Issuance Program that was approved on August 12, 2016, by the PBoC, with a total size of SDR 2 billion (approximately equivalent to USD 2.8 billion). The bonds were 2.5 times oversubscribed with around 50 orders; bank treasuries constituted the majority of demand.





GRAPH 12. PROFILE OF BIDDERS FOR WORLD BANK'S 3YR MULAN BONDS



Source: National Australia Bank, World Bank

This initial sale of SDR bonds might be the launch pad for continued growth in this new segment of the onshore fixed income market. The World Bank itself has room to issue another SDR 1.5 billion worth of bonds and both the Chinese government and the Industrial and Commercial Bank of China have been reported to be considering issuing SDR bonds.

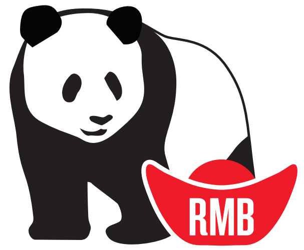
> The principal attraction of an SDR-based financial instrument, as for any other basket instruments, lies in the superior stability of returns it is capable of providing due to the diversification of currency risk, as well as in its convenience and cost advantage. The SDR serves as a convenient risk diversifier, because as a basket its value is based on component instruments that are imperfectly correlated with each other. As the total returns from such investment include both the currency gains/losses and the interest income in the investment currency, the SDR risk-reduction property accrues from both currency returns and interest income. From the exchange risk perspective, the SDR's stability primarily results from the fact that exchange rate shifts among the currencies in the SDR basket tend to offset one another, depending on the degree of correlations among the component currencies.

The role of SDR-denominated securities in official and private portfolios

BIS Papers No. 58;
George Hoguet and Solomon Tadesse

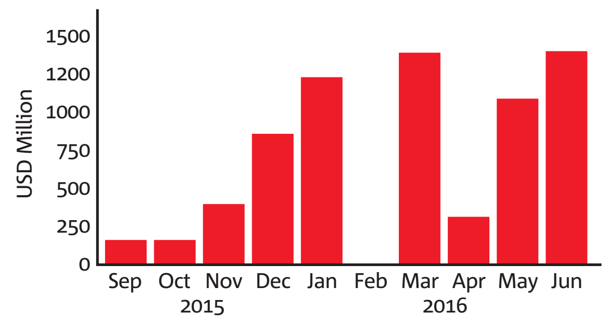
From Mulan to Pandas

After the well-received sale of its Mulan bonds, the World Bank said that it may explore issuing more Mulan bonds, or Panda bonds. Panda bonds are RMB-denominated bonds issued by foreign entities in mainland and were first introduced in 2005, but they have not enjoyed the same level of popularity as Dim Sum bonds, which were introduced in 2007 and are issued mainly in Hong Kong.



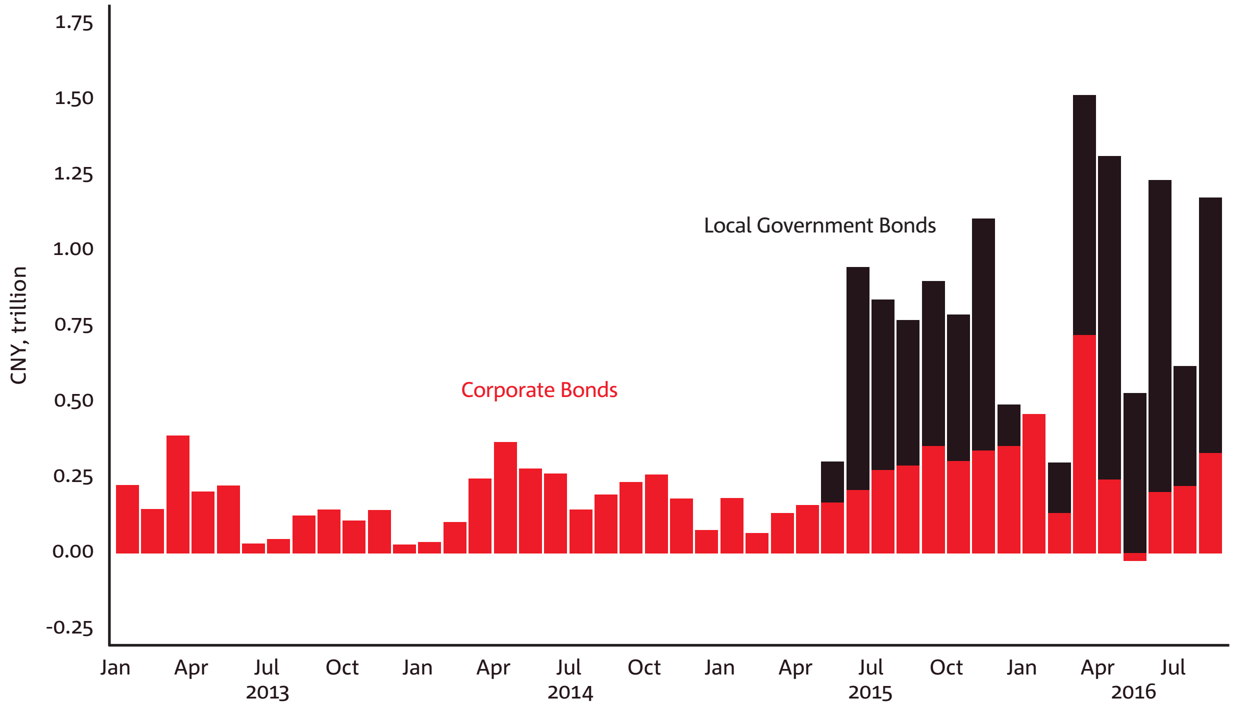
Panda bonds though began gaining more interest in 2015 when fears of a weakening in the RMB saw a rise in borrowing in RMB. The higher yield offered by Panda bonds made them more attractive vis-à-vis Dim Sum bonds. The opening up of the onshore debt market to foreign investors in February 2016 also aided the development of the Panda bond market. The first 7 months of 2016 has seen RMB 55.6 billion worth of Panda issuance, compared to RMB 68.3 billion Dim Sum bond issuance – this is a stark contrast to 2015 which saw just RMB 13 billion of Panda bond issuance, or less than 10% of what was seen in the Dim Sum bond market. With the authorities urging both corporations and local governments to shift away from bank loans to bonds to fund their borrowing needs, the onshore bond market is likely to grow quickly. Panda bonds will help fill the gap between the very safe Central Government bonds and the more risky onshore credit market.

GRAPH 13. CHINA: PANDA BOND ISSUANCE



Source: National Australia Bank, Macrobond

GRAPH 14. CHINA'S SURGE IN BOND ISSUANCE



Source: National Australia Bank, Macrobond

STRONGER AUSTRALIA-CHINA TRADE AND INVESTMENT LINKS

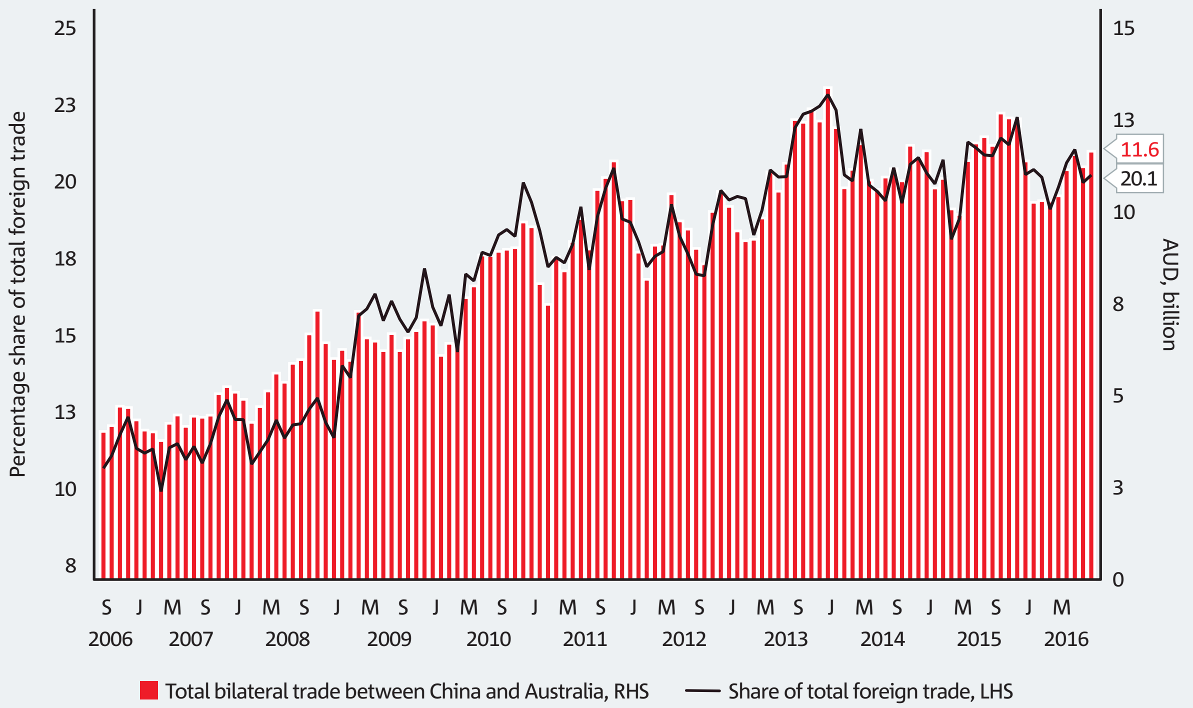
As Australia's economic integration with Asia continues to deepen, much of this will naturally be directly with China. China is now Australia's largest trading partner – over the last 10 years, the share of Australia's total merchandise trade that is done with China has more than doubled from around 10% to over 22% currently. Meanwhile, Australia is China's fifth biggest import source and tenth largest export destination. Meanwhile, China contributes 25% of Australia's total imports of manufactured goods and absorbs 13% of Australia's thermal coal exports.

As China's development continues, its continued infrastructure needs will ensure that Australia remains a vital trading partner. However, China's pivot towards consumption and its burgeoning middle class will likely shift its consumption patterns in part towards higher value food items, especially meat products, which should be another important addition to its bilateral trade.

Beyond meat products, the Australian parliament's recent commentary notes suggests that China's demand for more sophisticated manufactured goods and services is likely to grow and create greater scope for increased bilateral trade. Medical devices and tourism are already notable examples of these. The parliament's note also mentions Australia's ability in supplying specialised expertise in the areas of public sector works, health administration, education and social security; incidentally, these are also areas that China's government has highlighted as key focus policy areas.

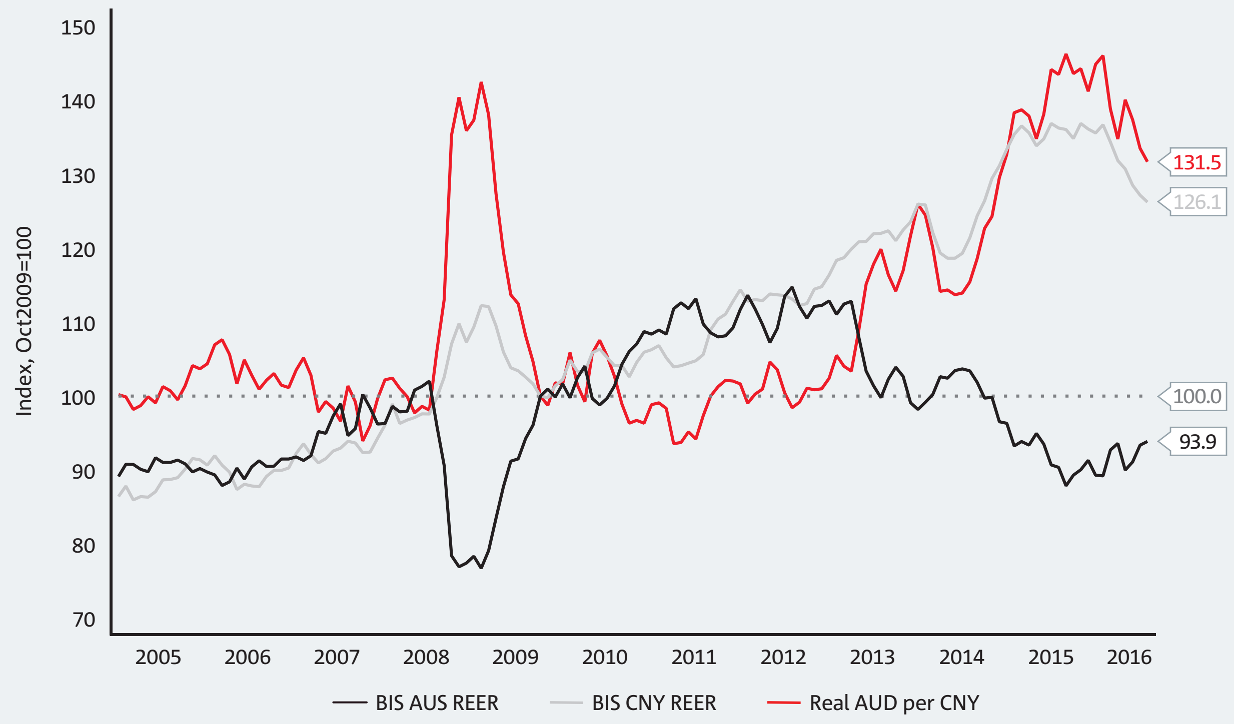
China's demand for resources is also likely to rebound in time. For now, China's economic reforms will leave investment demand somewhat anaemic. However, China's infrastructure needs remain substantial. The National Development and Reform Commission (NDRC) has revealed that it is targeting an expansion of the regular rail network to 150,000km and the high speed rail network to 30,000km by 2020, a 24% and 58% expansion respectively. The two networks will be further expanded to 175,000 and 38,000km by 2025. This should see all towns with populations of 200,000 connected to the regular rail network, and towns with 500,000 linked up to the high speed rail network.

GRAPH 15. CHINA-AUSTRALIA BILATERAL TRADE



Source: National Australia Bank, Macrobond

GRAPH 16. AUD AND CNY RELATIVE MOVEMENTS



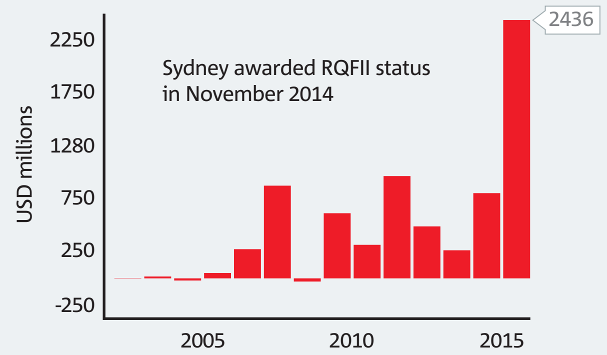
Source: National Australia Bank, Macrobond

Another factor that could lead to strong future growth in Chinese demand for Australian exports is the fact the real bilateral exchange rate has moved strongly in favour of the RMB since 2012 – the RMB has gained 37% against the AUD since Q4 2009. A large part of that has been the fall off in Chinese demand due to the need to rationalize domestic investment expenditure after the indiscriminate splurge post-GFC. Apart from the pressures that caused the AUD to fall almost 9% since Q4 2009 in real effective exchange rate terms, structural changes in the RMB management regime (partly in pursuit of IMF SDR status) has seen the RMB rise 28%. This increase in the relative purchasing power of the RMB should be a boon for demand whenever the Chinese authorities decide to ramp up infrastructure investment aggressively.

Beyond trade though, the growing two-way investment link is also something that will deepen the economic relationship. China's growing overall consumption and changing consumption basket should create greater scope for investment from Australian businesses to invest in China. The parliamentary note suggests that Australian business expertise with sophisticated manufactures and a large number of Mandarin-speakers in Australia creates significant scope for synergy.

The response to Australia's RQFII quota in November 2014 serves as perhaps a precursor to this and offers useful insight into the interest in gaining exposure to China's economy. Portfolio investment from Australia to China surged from USD 803 million in 2014 to USD 2436 million; pent-up demand no doubt accounts for some of that surge but the interest is still a valid interpretation.

GRAPH 17. PORTFOLIO INVESTMENT FROM AUSTRALIA TO CHINA



Source: National Australia Bank, Macrobond

THE POLICY TRILEMMA[1]

This is a macroeconomic framework, also known as "The Impossible Trinity" or simply "The Trilemma", that says that at any one time, on 2 out of the following 3 policy objectives – free capital flows (or financial integration), exchange rate stability and monetary autonomy – can be achieved.

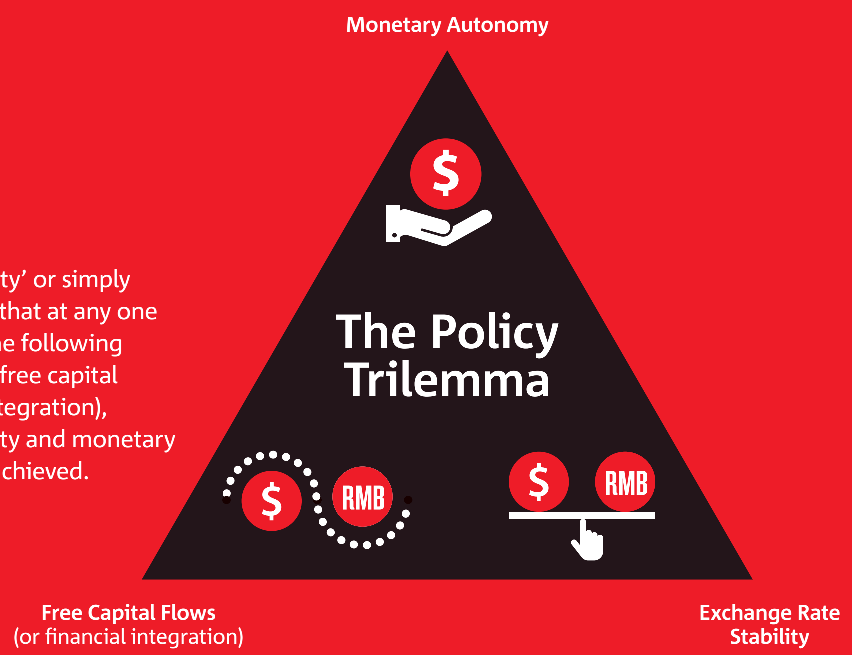
The Trilemma is an outgrowth of the Mundell-Flemming framework when applied to the open economy variant of the IS-LM neo-Keynesian macroeconomic model. The Trilemma is generally accepted as a valid framework in academic and policymaking circles despite some difficulty in testing the predictions of the model because of the vagaries of measuring the key variables in the Trilemma.

Although the Trilemma is usually portrayed in stark "either-or" binary terms, the trade-off can exist in a continuum, where mixed currency regimes (like a managed float) co-exist with partial financial integration, along with reduced monetary independence. China's current situation offers a very good illustration of the need to juggle these 3 policy objectives.

Historical data for industrial countries supports the validity of the relationships laid down by the Trilemma. After the Bretton Woods system ended, exchange rate stability fell amongst industrial countries until the early 1980s. The 1990s through to 2006 saw an increase in exchange rate stability and financial integration both rose, in line with the introduction of the Euro. The observations of a decline in monetary autonomy fit the predictions of the Trilemma quite well. Emerging market countries meanwhile seem to have opted to sacrifice monetary independence and currency stability in exchange for more financial integration, over the same period.

In general, the literature and historical experience suggest the choice of which specific Trilemma position to adopt depends on the policy priorities of the economic managers and what they perceive the economy's challenges to be. Higher monetary autonomy tends to be linked to reduced output volatility while greater currency stability has been linked to higher output volatility, although this can be mitigated by keeping the currency broadly undervalued. Inflation is also another target variable – monetary autonomy tends to have a direct relation with inflation, while currency stability and financial integration tend to have an inverse relationship with inflation. Financial integration, meanwhile, if accompanied by a high level of financial development, can curtail output volatility. However, in China's case, the transition period could entail an increase in output volatility as its domestic financial markets are still fairly shallow and cannot easily absorb large inflows and outflows.

'The Impossible Trinity' or simply 'The Trilemma', says that at any one time, only 2 out of the following 3 policy objectives – free capital flows (or financial integration), exchange rate stability and monetary autonomy – can be achieved.



1. Aizenman, J. (2010, May). The Impossible Trinity (aka The Policy Trilemma). Encyclopedia of financial globalization.

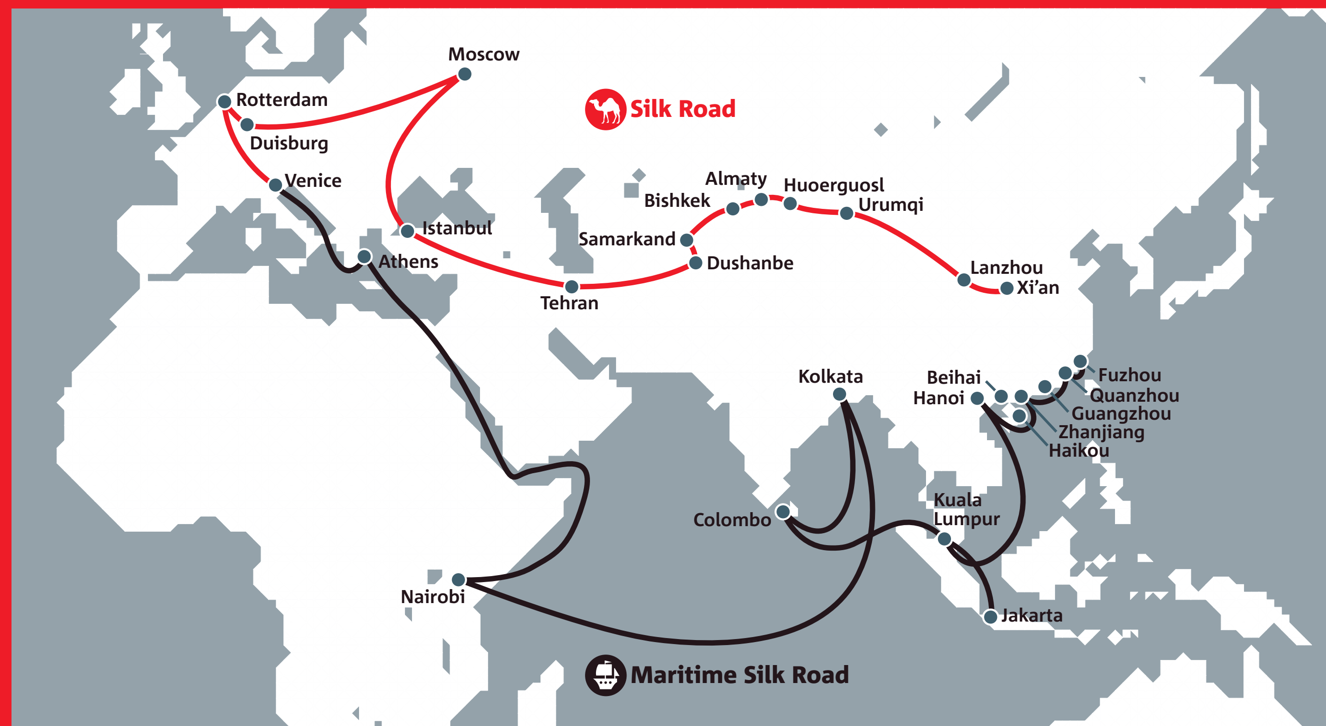
ONE BELT, ONE ROAD

Another initiative that is mostly seen as a charm offensive on China's part is its New Silk Road initiatives, also known as One Belt, One Road (commonly abbreviated as OBOR). The initiative, while indeed likely to have significant diplomatic imperatives, could also increase the regional use of the RMB given the fact that much of the financing is likely to come from China[2].

In September and October 2013 respectively, China's President Xi Jinping unveiled the land- and sea-based legs of OBOR[3]. The New Silk Road Economic Belt is the land-based leg of the initiative and will connect China to Europe via Central Asia by road and rail. The other leg, the Maritime Silk Road, will likely connect the southern coast of China the key coastal trading hubs in South-east Asia, South Asia and Africa, before linking up with European trading ports in the Mediterranean via the Suez Canal.

President Xi has pledged USD 40 billion into a New Silk Road fund to "break the connectivity bottleneck" in Asia by investing in infrastructure and facilitating industrial and financial cooperation. The official China Securities Journal has reported that a "Maritime Silk Road Bank" will be established with a minimum paid-in capital of RMB5 billion. Additionally, towards the end of 2014, the China Silk Road Limited Liability Company was founded with paid-up capital of USD 10 billion, all from China's sovereign wealth fund (China Investment Corporation), 2 policy banks (China Development Bank and Export Import Bank of China) and the State Administration of Foreign Exchange. The 2 aforementioned policy banks have also received USD 62 billion[4] worth of capital injection drawn from China's massive foreign exchange reserves. The Silk Road Fund (SRF) is chaired by an assistant governor of the PBoC.

Although funding details are generally still quite scant, it is likely that the OBOR initiative will be linked up with China's drive to make the RMB one of the currencies of choice for regional trade and investment transactions.



Source: Xinhua finance http://en.xinfinance.com/html/OBAOR/

2. The Economist Intelligence Unit. (2015). *Prospects and challenges on China's 'one belt, one road': a risk assessment report*. London: The Economist Intelligence Unit Limited.

3. The State Council of the People's Republic of China. (2015, March 12). *Silk Road Fund to start investment soon*. Retrieved September 7, 2015, from English.gov.cn: http://english.gov.cn/news/top_news/2015/03/12/content_281475070261656.htm

4. Wildau, G. (2015, April 20). China backs up silk road ambitions with $62bn capital injection. *Financial Times*.

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Our broad geographical focus

Supporting trade and investment flows between Australia/New Zealand and Hong Kong, Singapore, Japan, China, India, Indonesia and Vietnam.

Our strong customer focus

- Corporates and institutions in key industries – food/agriculture, energy/resources and infrastructure.
- Major financial institutions in the region
- Australian/New Zealand corporates linked to Asia and Asian corporates with interests in Australia and New Zealand.
- Asia-active Australian/New Zealand small and medium enterprises (SMEs).
- High net worth customers in Hong Kong, Singapore and Japan with Australian/New Zealand lending or deposit needs.

Our product offerings

Product capabilities

Lending: corporate loans (term, revolving, bank guarantees) and syndications

Deposits: savings accounts and term deposits

Trade finance: a suite of trade finance solutions including:

- Import: letters of credit (back to back, standby credits, transferable), collections, shipping guarantee
- Export: letters of credit (advising, confirmations, negotiation, and discounting)
- Documentary collections
- Trade loans, trade bill financing
- Open account financing and trust receipt financing
- Financial institutions trade refinance loans
- Structured trade finance

Foreign exchange: We can deal in most Major and Emerging markets currencies, with some exceptions.

Cross border payments: inwards and outwards payments in our available foreign currencies (SWIFT).

Our service offerings

Introductions & foreign direct investment

- With well-connected NAB personnel on the ground in China and throughout Asia, we can connect our clients into key markets to help them achieve their aspirations in the growing Asia region.
- We can assist with business to business connectivity and introductions helping our customers navigate unfamiliar markets.
- We can provide information and advice to our clients needing onshore cash management and transactional banking services including referrals to local banks.

APPENDIX

TABLE 1. MEASURES TO LIBERALISE THE RMB BEFORE AND UP TO SDR ENTRY ANNOUNCEMENT

Period	Policy adjustment
JUL 2005	USD/CNY revalued from 8.27 to 8.11 and allowed to trade in a narrow band of 0.3% on either side of a daily central parity rate. USD-peg replaced by peg to trade-weighted basket.
AUG 2005	People's Bank of China states that the trade-weighted basket dominated by USD, JPY, EUR and KRW. The GBP, THB, RUB, AUD, CAD and SGD make up a smaller portion.
MAY 2007	USD/CNY trading band widened to 0.5%
DEC 2010	RMB begins to trade against the Russian Ruble
APR 2012	USD/CNY trading band doubled to 1%
JUN 2012	RMB begins to trade against the Japanese Yen in Tokyo and Shanghai
APR 2013	RMB starts to trade against the Australian dollar
MAR 2014	USD/CNY trading band doubled to 2%
AUG 2015	Mechanism that determines the daily USD/CNY central parity adjusted to include previous close and major currency movements, in addition to demand and supply conditions as assessed by major onshore banks.
OCT 2015	Deposit rate ceiling removed, allowing full interest rate liberalisation.

TABLE 2. CAPITAL ACCOUNT LIBERALIZATION: QFII, RQFII, SHANGHAI-HONG KONG STOCK CONNECT

Key capital account liberalization measures	Significance
Bilateral swap agreements	30 swap agreements have been opened with various central banks and monetary authorities. These total more than RMB 3 trillion and are meant to provide liquidity in support of settlement of trade transactions in RMB.
Shanghai-Hong Kong Stock Connect	Launched in 2014, this scheme is another measure that increases cross-border equities flows. The stock connect allows investors in either jurisdiction to purchase shares in the counterpart's stock market. The 'northbound' (HK investors into Shanghai) limit is RMB 300 billion in total and RMB 13 billion daily. The 'southbound' limit is RMB 250 billion in total or RMB 10.5 billion daily. The Shenzhen stock market is scheduled to join the scheme in late-2015.
Qualified Foreign Institutional Investor (QFII) scheme	Allows foreign institutional investors who meet certain criteria to invest in onshore securities. As of April 2015, a total of almost USD 74 billion worth of quotas had been awarded to 268 institutions.
RMB Qualified Foreign Institutional Investor (RQFII) scheme	This parallel scheme allows qualified foreign institutional investors to invest their overseas RMB in onshore Chinese securities. As of May 2015, more than RMB 382.7 billion (of the total RMB 970 billion approved) worth of RQFII quotas had been awarded to 129 foreign institutions. (http://www.bloomberg.com/offshorechina/rqfii/)
RMB Offshore Clearing Centres	These clearing centres allow the offshore purchase for RMB and facilitate both the RQFII programme and settlement of trade transactions in RMB. As of Oct 2015 there were 15 clearing centres mostly in Asia and Europe.
Cross-border interbank payment system (CIPS)	Planned international payments system to help facilitate trade settlements in RMB. CIPS will connect the global system of RMB clearing banks. Phase 1 started operation in October 2015.

Source: National Australia Bank, Bloomberg

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