A Perspective on RMB as a Reserve Currency

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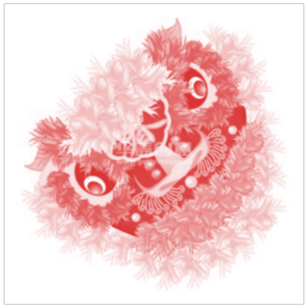
THE PEOPLE'S BANK OF CHINA

Outline

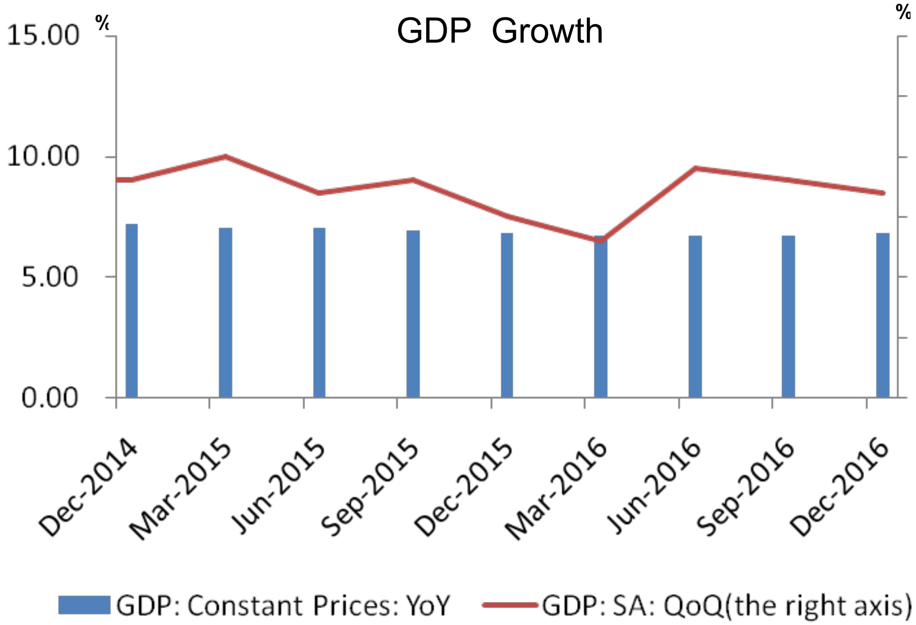
- **Macroeconomy** — stable, positive and strong
- **Monetary and FX policy** — principle based policy making with strong fundamentals, long-term stability and predicability
- **RMB as a reserve currency** — great diversity of offerings, wide access and exit options with attractive yield and structural stability

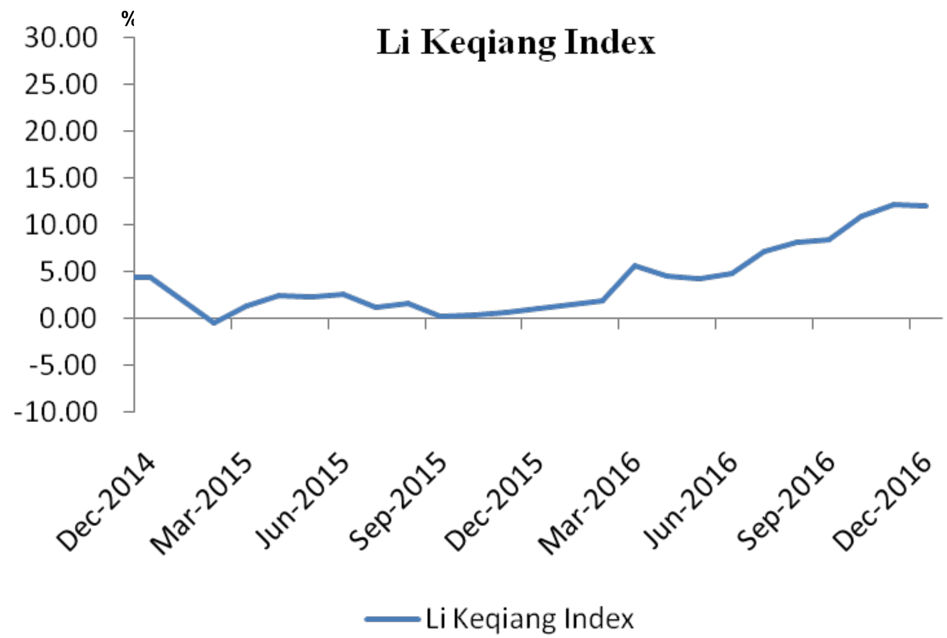


Macroeconomy

- Economic growth stable and warming up
- Consumptions, investments and exports on the upswing
- CPI reaching target area with rising PPI
- Labor market better than expected
- Fiscal condition sound with room to expand
- International balance of payments getting healthier
- Financial risks ahead cautiously watched

Economic growth stable and warming up

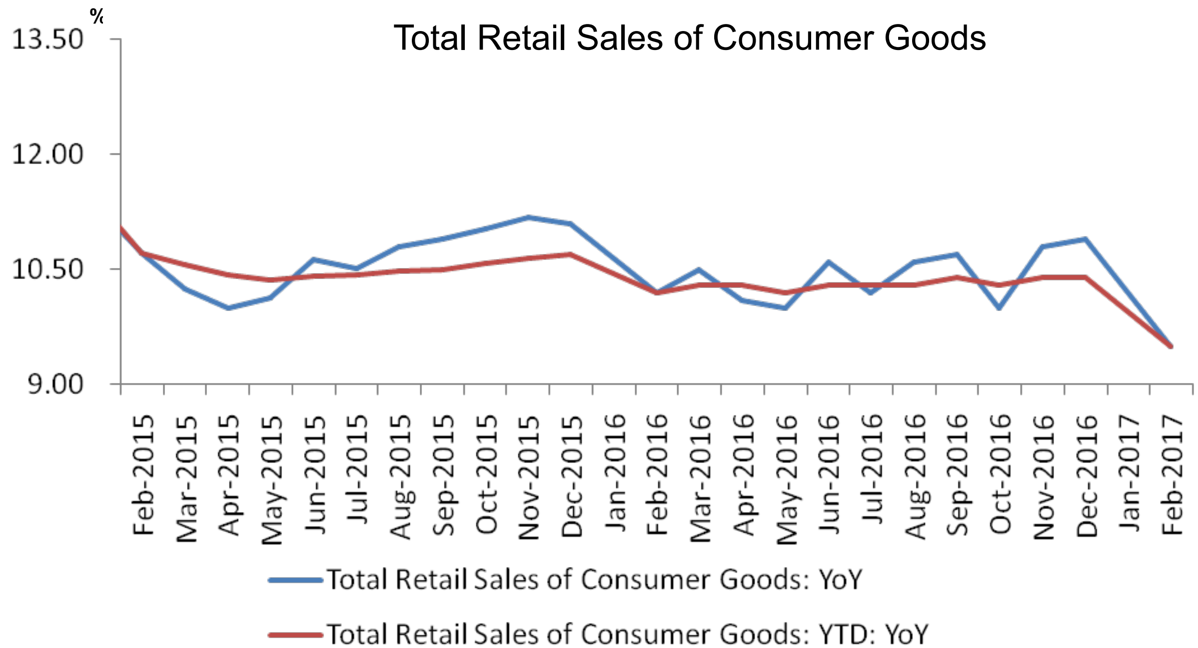




Overview

- GDP grew by 6.7% in 2016, compared with 6.9% in 2015.
- The quality of economic development is improving, with the supply-side reform going on.
- Li Keqiang Index has rebounded since Dec 2015.

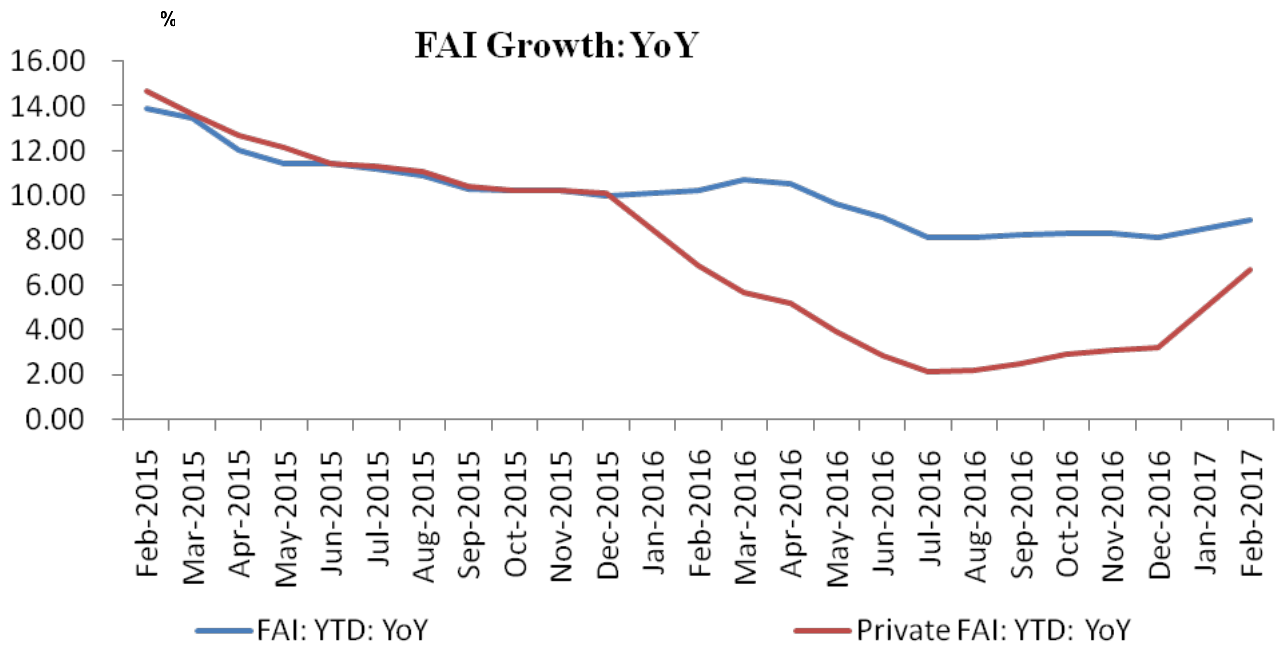
Consumptions dropped unexpectedly but anticipated to be stable



Overview

- The growth of retail sales of goods increased by 9.5% YoY in Feb 2017, the second drop since this year partially due to dipping CPI during the same period.
- CPI is expected to be stable or upward according to the most recent 2017 Q1 survey on resident deposits and consumptions tendency hosted by PBoC.

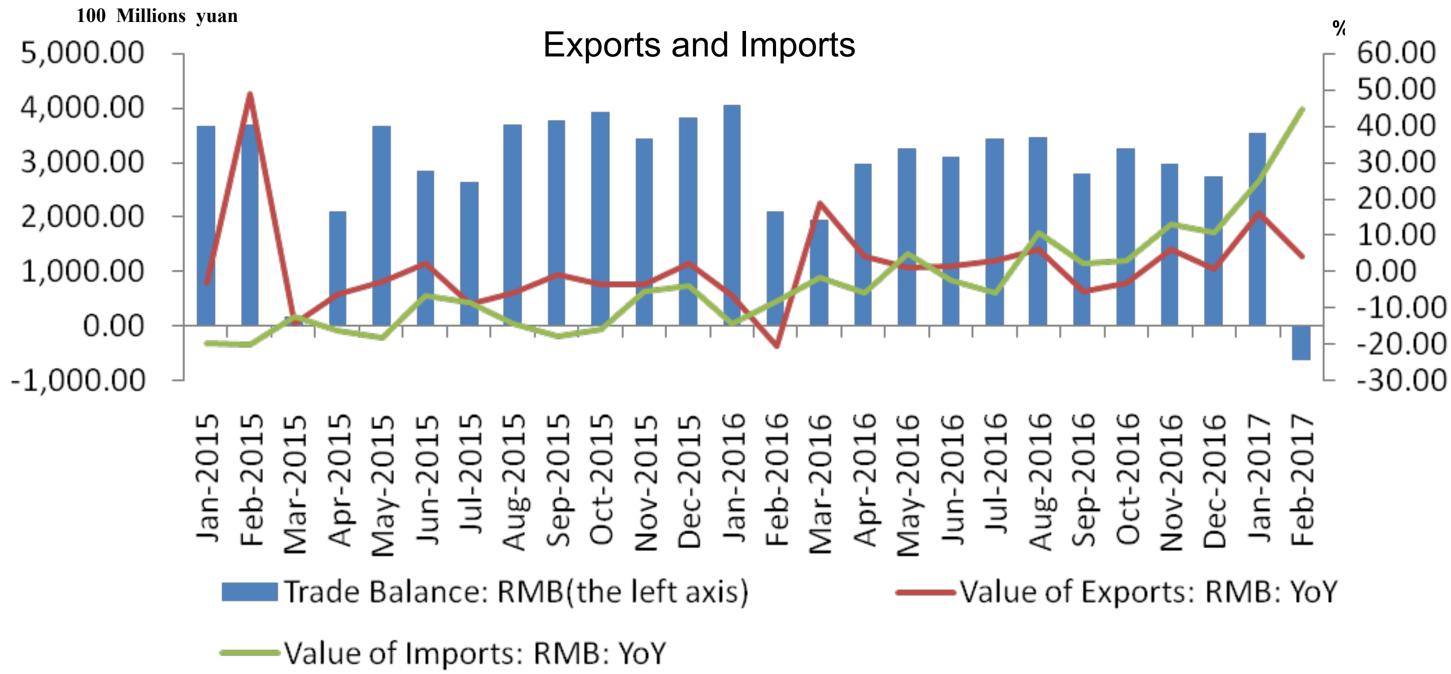
Fixed-asset investments and private investments rebounding



Overview

- The growth of fixed-asset investments remain stable.
- Private fixed-asset investments rebounded significantly since 2017.
- Additionally, the growth of real estate investments kept stable and infrastructure investments rebounded markedly.

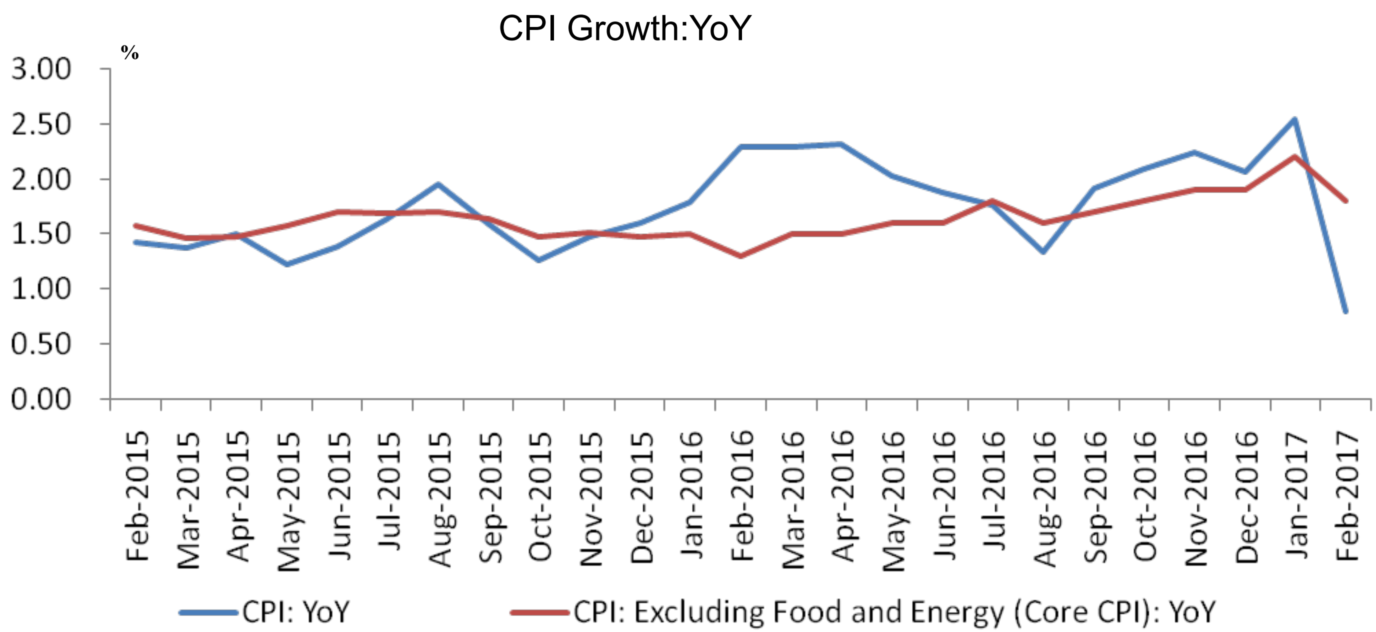
Imports soaring with exports fluctuating upward, implying booming domestic and international demand



Overview

- China witnessed a surprise trade deficit in Feb 2017, first time since 2014.
- Exports and imports increased by 4.2% and 44.7% YoY in Feb 2017, compared to 25.2% and 7.9% respectively in January.
- Imports surged dramatically due to warming domestic demand and soaring bulk commodity

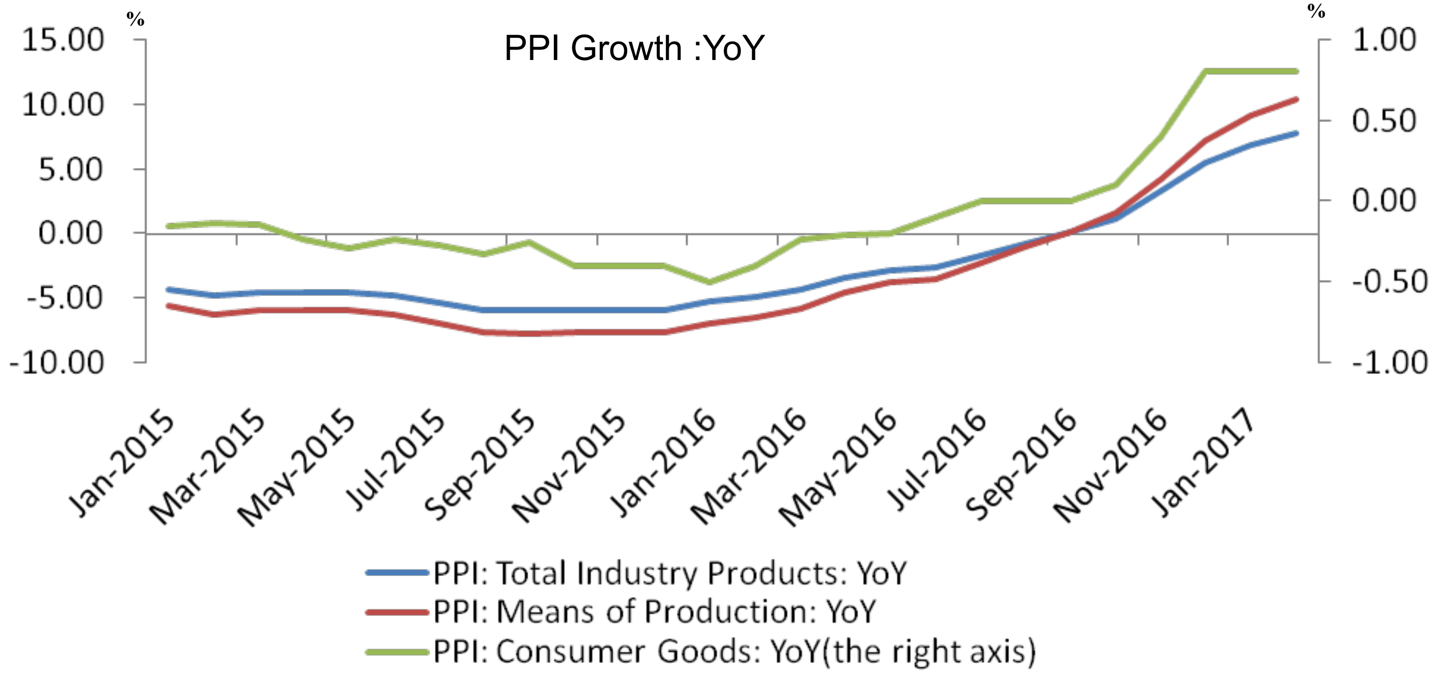
A sharp drop in CPI growth mainly due to carryover effects



Overview

- Comparatively, CPI in Feb 2016 was high due to the Spring Festival and abnormal cold weather.
- CPI fell to 0.8% YoY in Feb 2017 while core CPI fell to 1.8% YoY, with food prices dropping markedly.
- Price level of other components of CPI, such as health care, housing, education, culture & entertainment, transportation & communication, and clothing & other daily services, were rising.

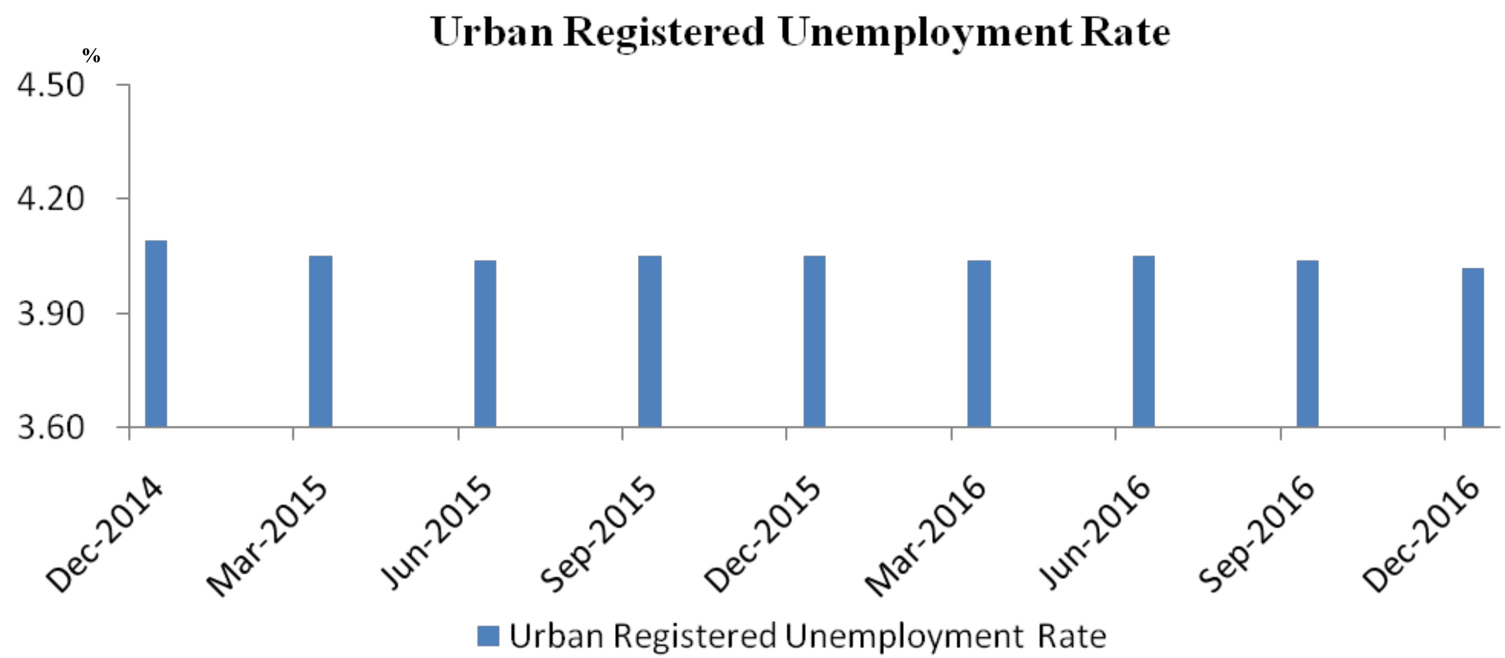
Climbing PPI due to soaring raw material prices



Overview

- After Sep 2016, PPI kept rising and became positive, first time since 2012.
- PPI increased by 7.8% YoY in Feb 2017； and PPI for means of production increased sharply, meanwhile PPI for consumer goods edged up mildly.
- The soaring oil, coal and metal prices drove PPI up.

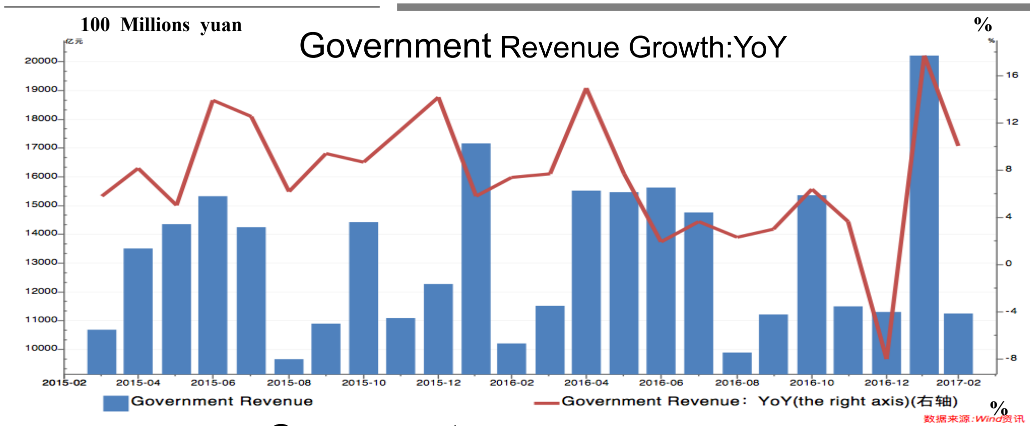
Unemployment rate remains low and slightly dipping

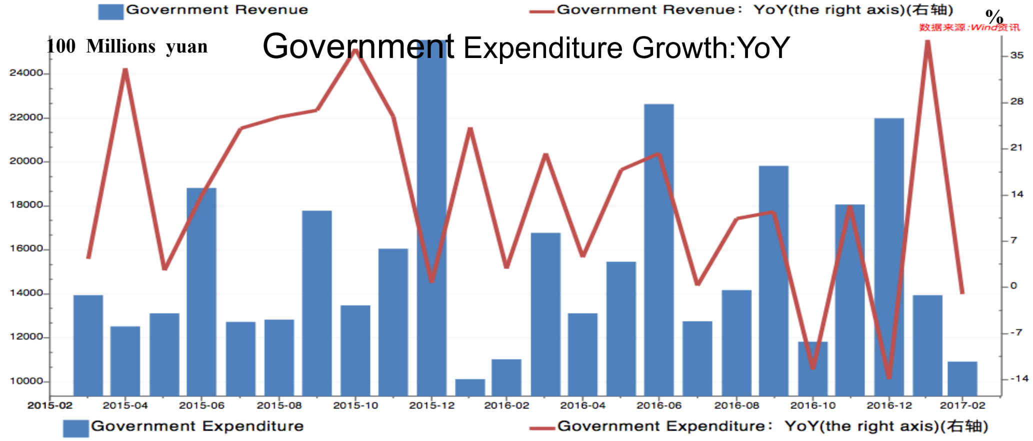


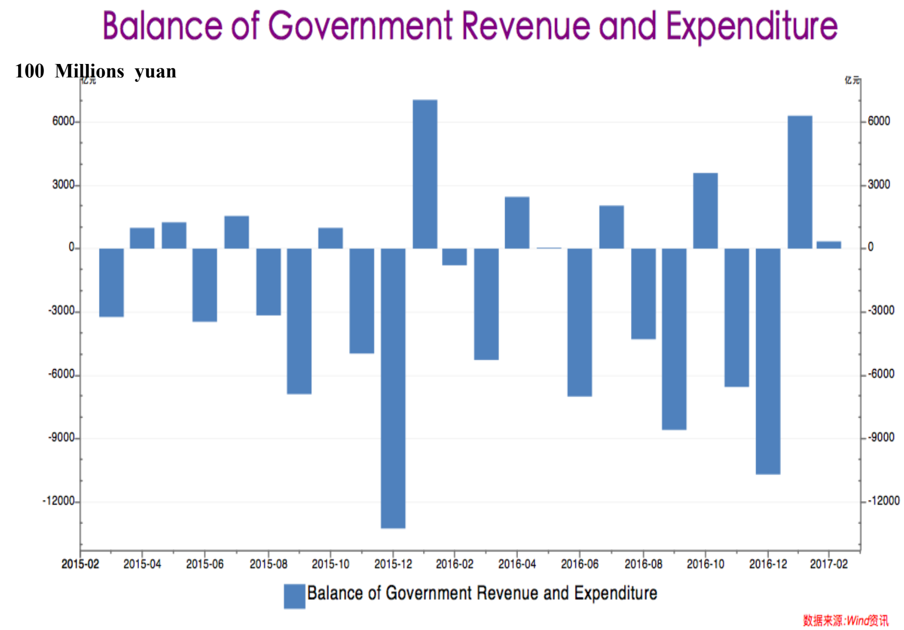
Overview

- The registered urban unemployment rate stood at 4.02% at year-end 2016, the lowest level in years.
- A total of 13.14 million new urban jobs were added over the course of the year of 2016, significantly exceeding initial projection at 10 million.
- The new created jobs target in 2017 will be at 11 million.

Government balance sheet remains healthy with room to expand



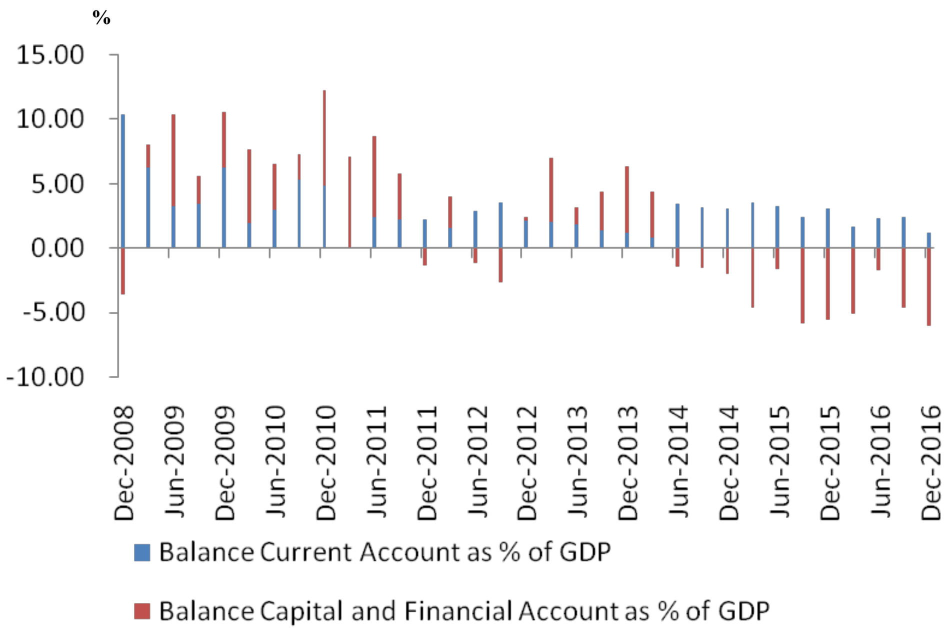


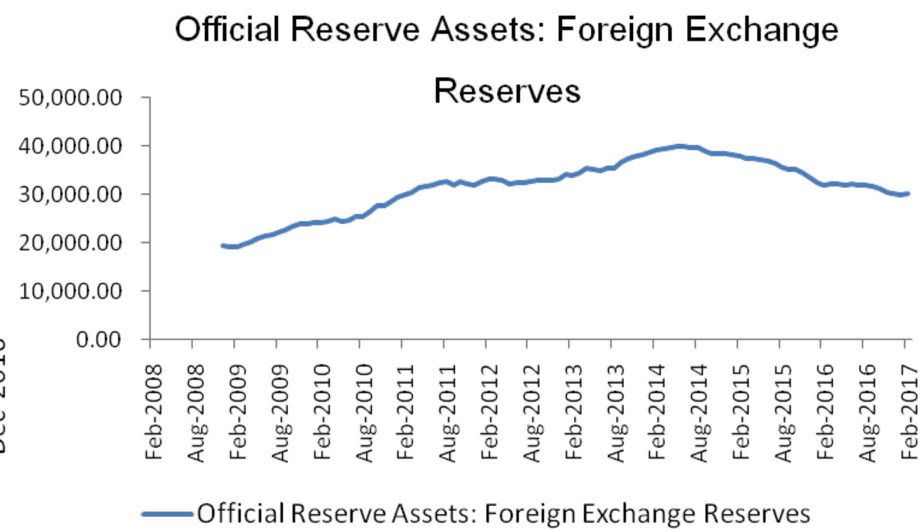


Overview

- The government deficit in 2016 was 3.8% of GDP.
- Budget deficit target for 2017 is at the same level as 2016.
- China has room to apply more fiscal stimuli if the economy needs support again.

International balance of payments getting healthier

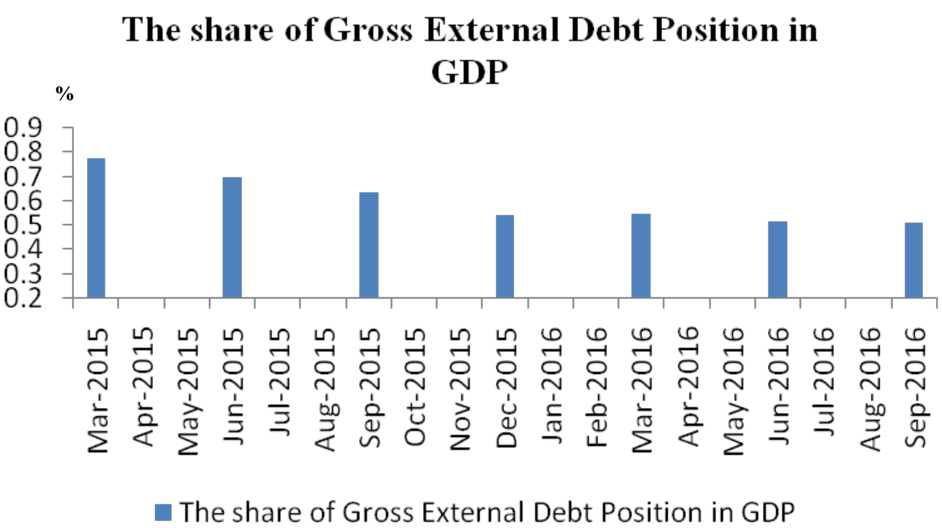


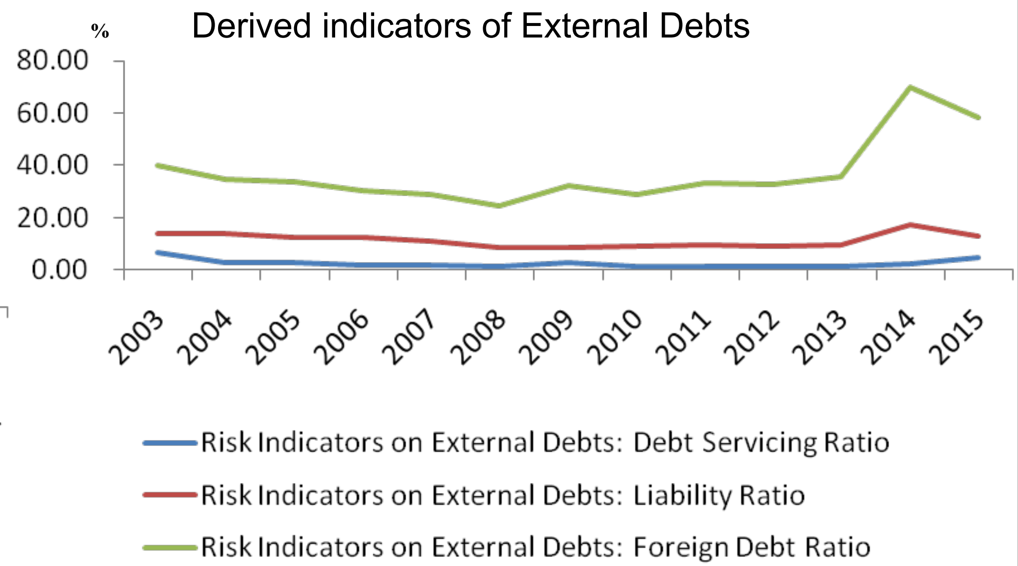


Overview

- Current account surplus to GDP ratio reduced significantly while capital and financial account deficit to GDP ratio went up dramatically.
- Capital out flow increasing since H2 of 2014, resulted in foreign exchange reserve contraction from its $3.99 trillion record peak to its most recent level of $3.005 trillion in Feb 2017.

Foreign debt shrank with external risks getting more manageable

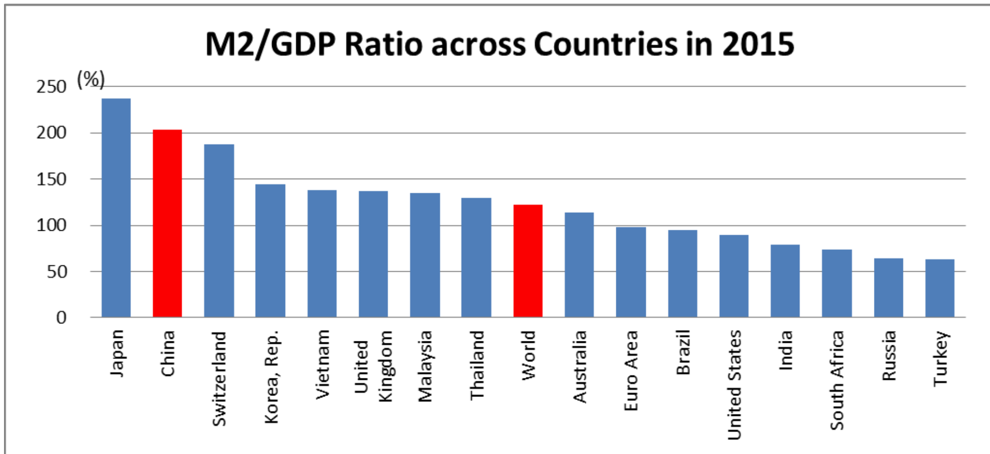


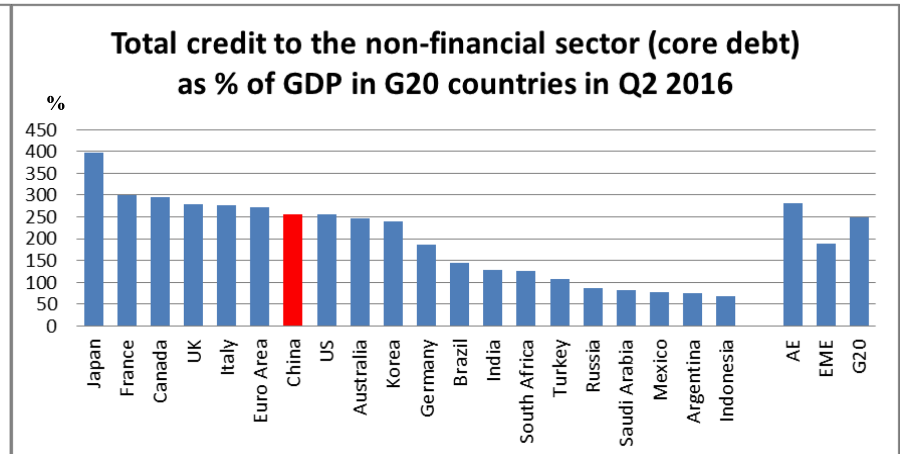


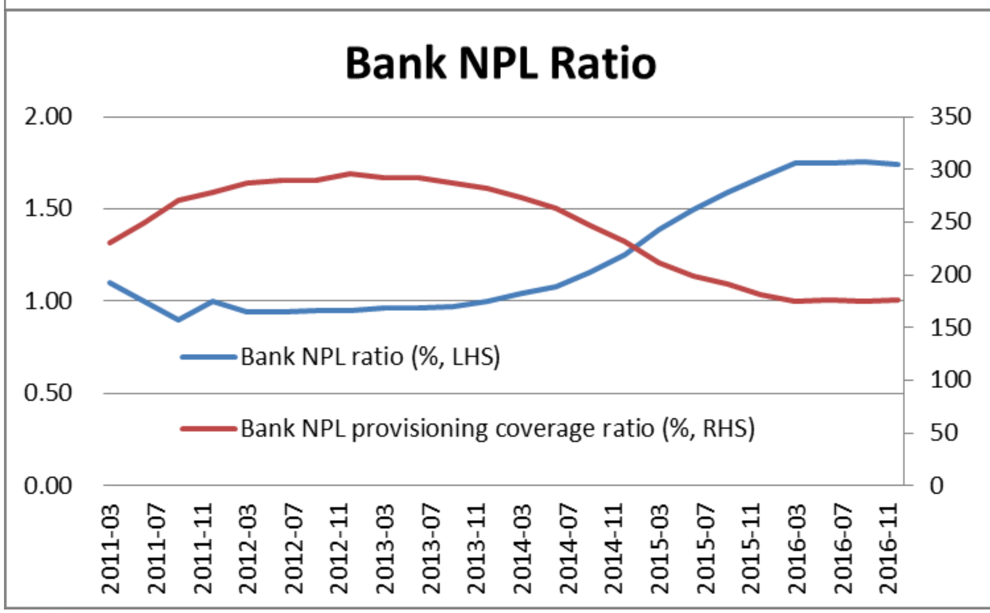
Overview

- The share of gross external debt position continued to decrease with foreign debt risks becoming more manageable. At the end of Q3 2016, total foreign debt accounted for 18% of GDP.
- External debts remained sound. In 2015, the debt-servicing ratio was around 5%. The liability ratio was around 13%. The foreign debt ratio was 58.3%.

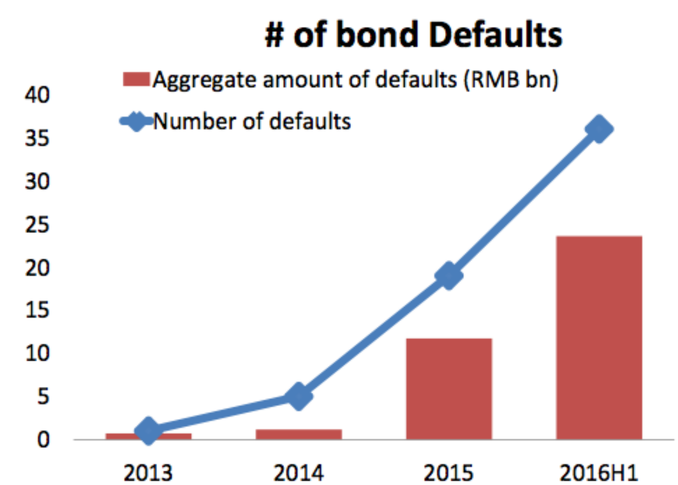
Financial Risks ahead







Rise in # of defaults in the bond market

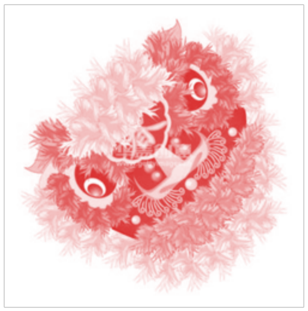


Emerging systemic financial risks and policy responses

- Emerging systemic financial risks include
  - High leverage ratio
  - Bond and housing market risks
  - Volatile cross-border capital flows
- Policy responses should focus on shadow banking regulation, regulatory coordination, and financial infrastructure, so as to
  - improve the two-pillar mechanism of "monetary policy and macro-prudential policy"
  - curb credit flow to speculative activities
  - deepen financial reform and improve corporate governance
  - promote convergence of domestic and international standards
  - build robust financial market infrastructure
  - enhance regulatory coordination
  - establish and improve risk monitoring and resolution mechanism across different sectors and markets.

2017 macro forecasts, with upside risk

China Macroeconomic Forecasts (yoy%, or %)			
	2015	2016	2017F
Real GDP	6.9	6.7	6.5
Fixed asset investment	10	8.1	9.1
Retail sales	10.7	10.4	10.6
Exports	-2.9	-7.7	1.8
Imports	-14.2	-5.5	3.0
Trade balance/GDP	5.3	4.6	4.1
CA balance/GDP	2.7	2.5	2.0
CPI inflation	1.4	2	2.4
PPI inflation	-5.2	1.4	5



Monetary and FX policy

- Influence of U.S. interest rate hike diminishing
- Prudent and neutral monetary policy slightly tightens in 2017
- Foreign exchange policy sticks to opening-up and consistent principles
- No evidence of fundamental changes implying significant RMB exchange rate depreciation
- Macro-prudential management of cross-border capital flow, in stead of capital control, has been, and will continue to be enforced

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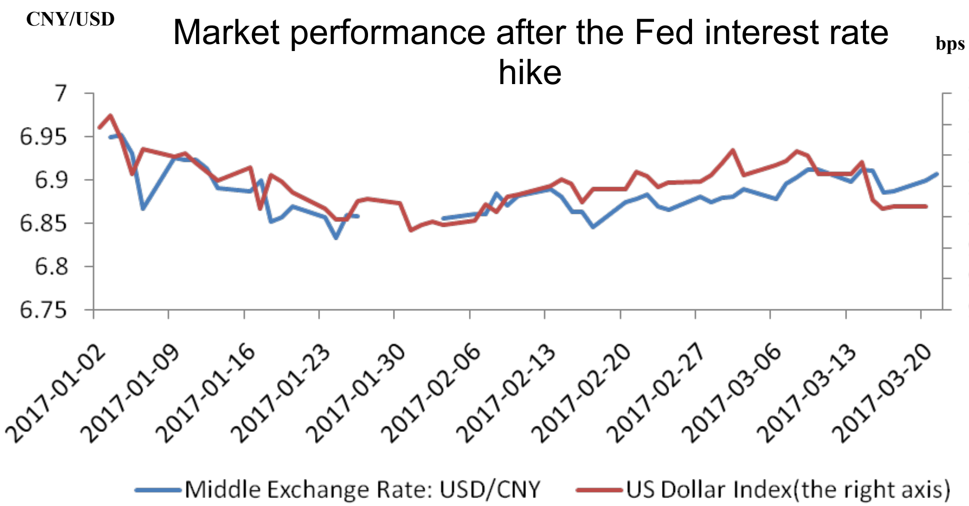
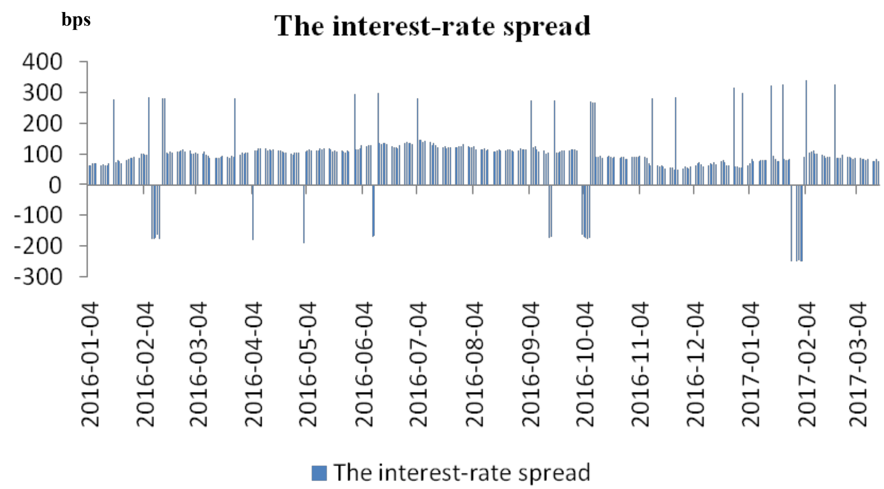
The U.S. interest rate hike impact diminishing





Overview

- Fed interest rate hike was fully anticipated and the impact was digested by the market quickly.
- The influence was limited and overall neutral to China.
- The dollar index fell 1%, and the RMB exchange rate remained relatively stable.
- The spread between Chinese and US 10-year bond yields is narrowing.

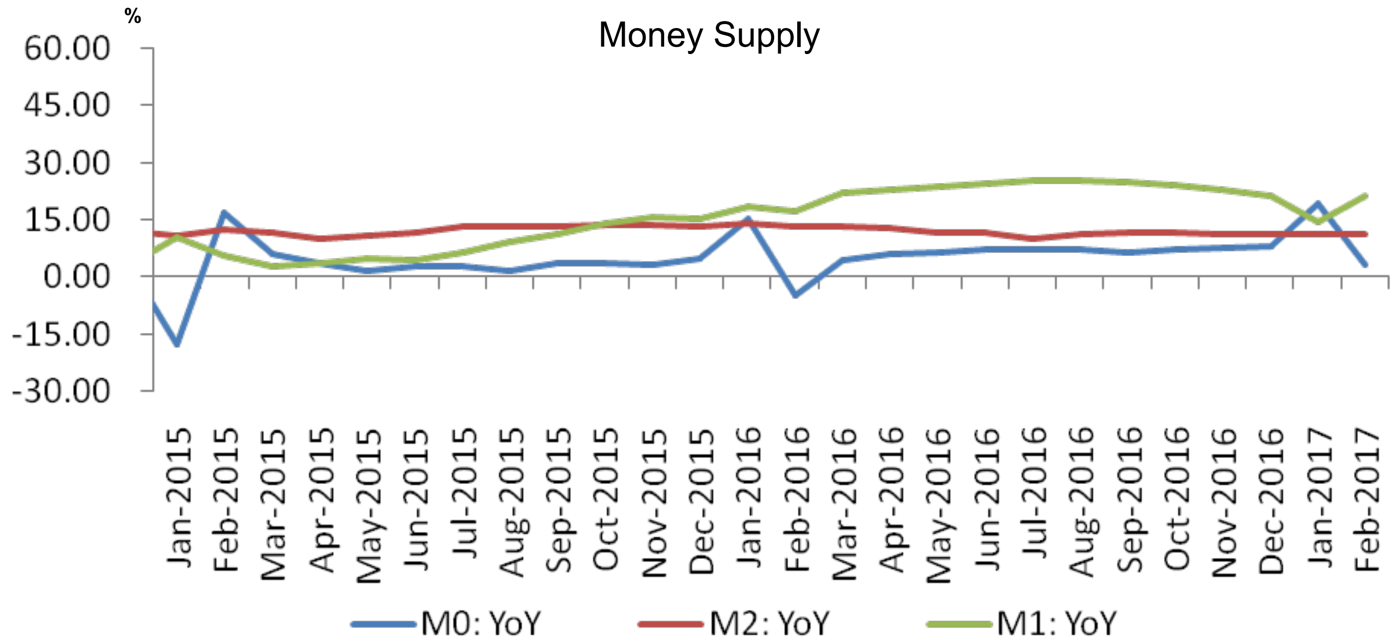
China exercises prudent and neutral monetary policy as well as macro-prudential policy

- Generally, China is improving the two-pillar mechanism of "monetary policy and macro-prudential policy", and adhering to a prudent and neutral monetary policy stance, so as to prevent systemic risks, specifically to
  - Further promote supply-side reform
  - Guide enterprises to cut inventory and overcapacity
  - Prevent asset bubbles
  - Deleverage
  - Reduce financing costs
  - Protect vulnerable sectors

2017 monetary policy slightly tighter

- The 2017 monetary policy stance is prudent and neutral, slightly tighter than last years', to
  - prevent an excessive M2-GDP growth differential, i.e., a rapid increase in macro-leverage ratio
  - ease property market overheating
  - curb possible inflationary pressure
  - watch capital flight cautiously and further liberalize the RMB exchange rate
  - maintain the RMB's stable position in the global monetary system

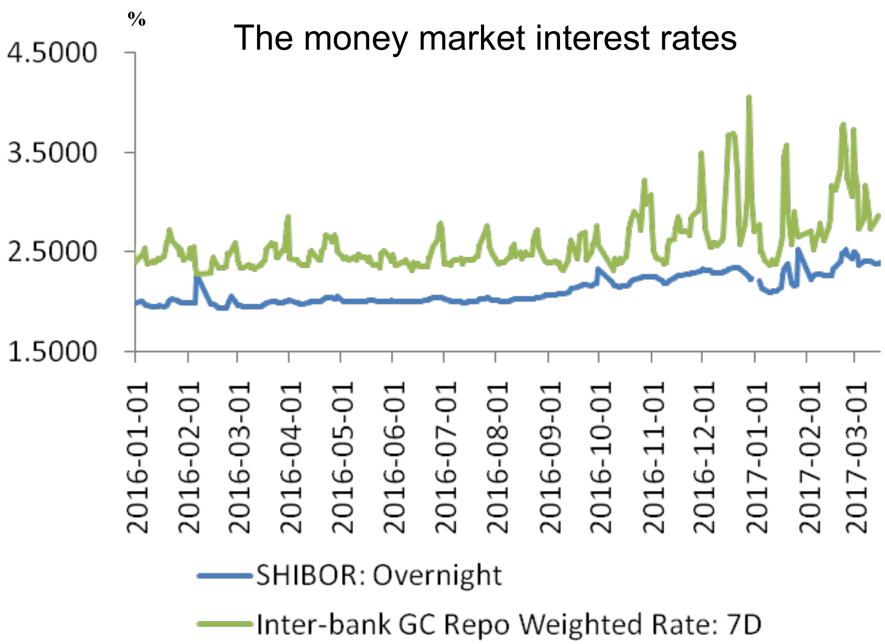
Money supply on the right track

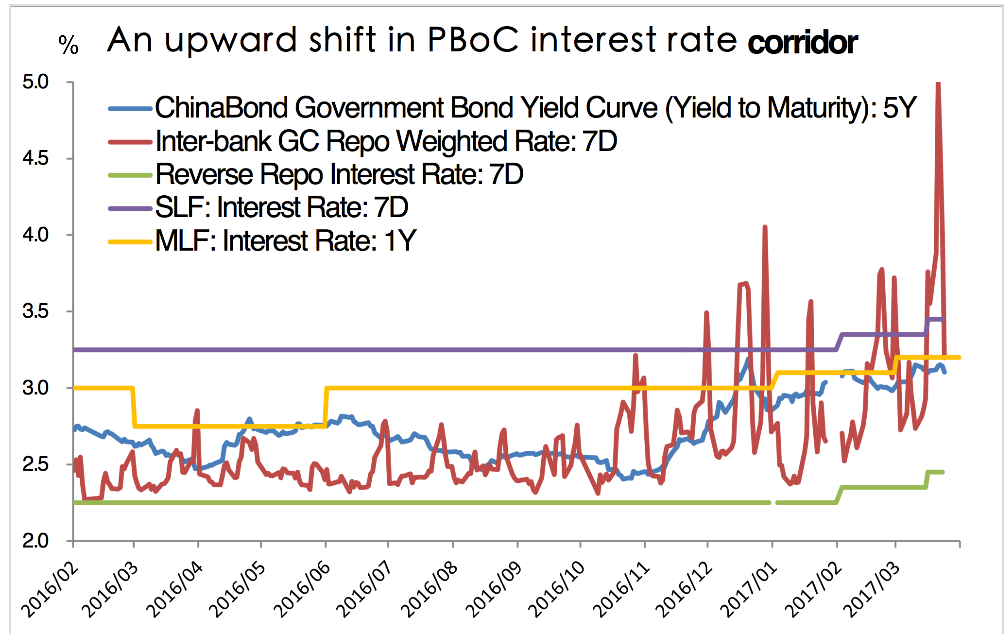


Overview

- Money supply fluctuated due to Spring Festival factors, but expected to be back on the right track.
- M0 increased by 3.3% YoY in Feb 2017, 16.1% lower than that in Jan 2017.
- M1 increased by 21.4% YoY in Feb 2017.
- M2 increased by 11.1% YoY in Feb 2017.

Money market rates and bond yields trending upward





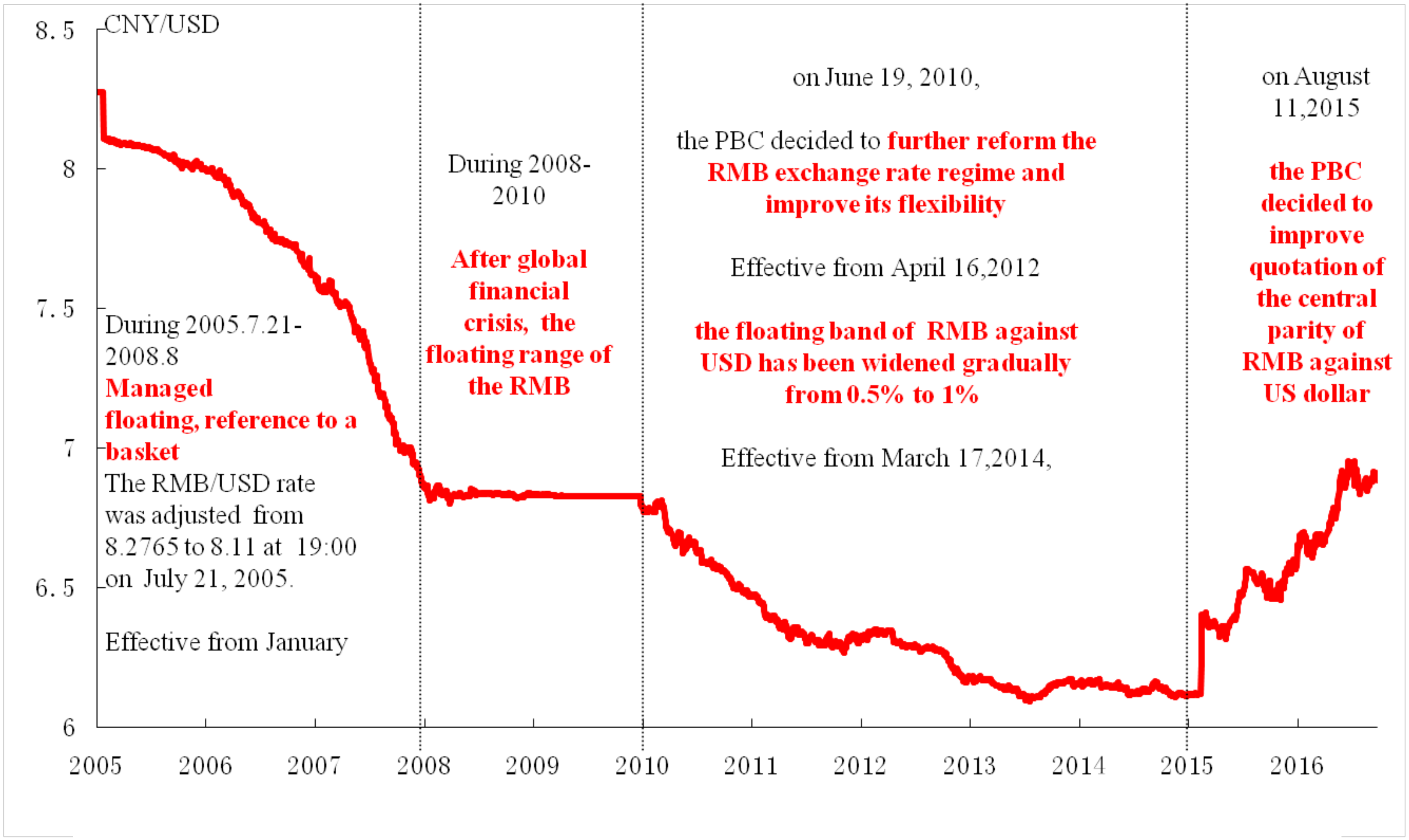
Overview

- The money market rate volatility widened since Nov 2016 with a slight upswing tendency.
- PBoC's reverse repo and MLF bid rate went up 10bps on March 16 as a result of market bidding.

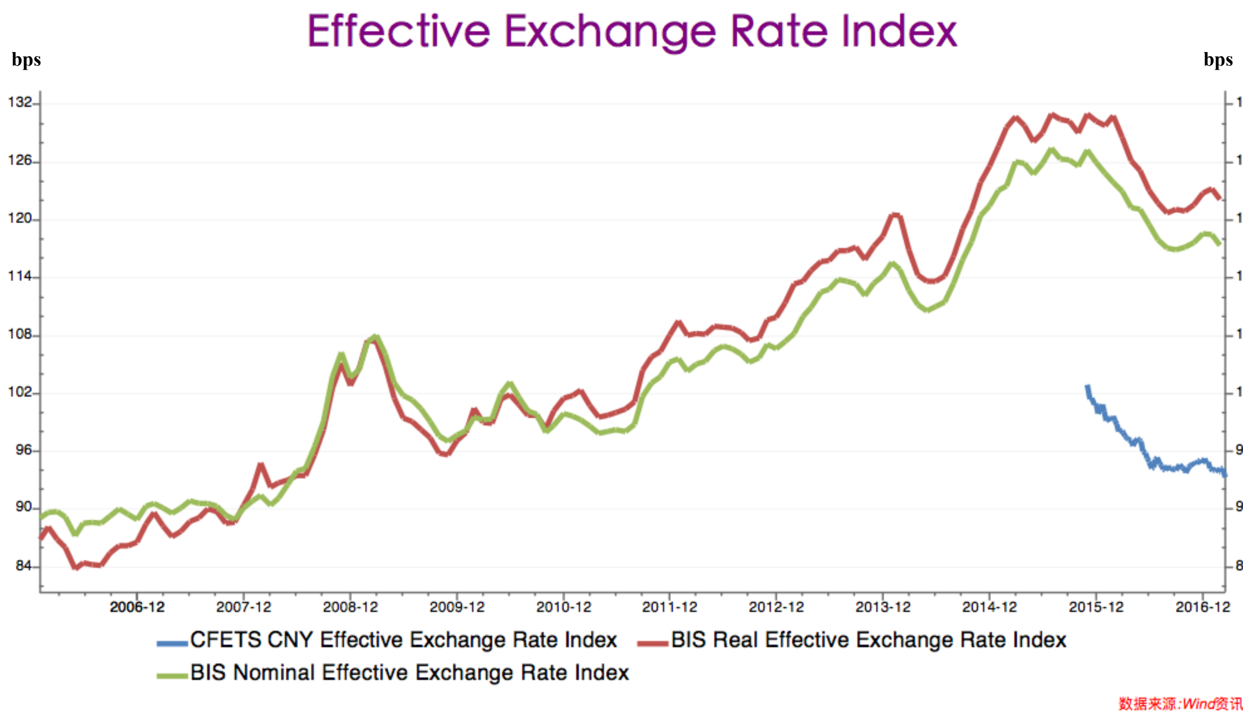
Foreign exchange policy adhering to opening-up and consistent principles

- The RMB exchange rate regime has been on the right track of liberalization
- No evidence of fundamental changes implying significant RMB exchange rate depreciation
- Foreign exchange policy remains forward-looking and consistent in terms of liberalizing and opening-up
- Macro-prudential management of cross-corder capital flow, in stead of capital control, has been, and will continue to be enforced

RMB exchange rate greatly liberalized since July 2005



RMB depreciation pressure relaxed recently as shown in effective exchange rates



Overview

- Since Aug 2015, both the real and nominal effective exchange rates of RMB continued to decline with fluctuations, but became relatively stable recently.
- The CFETS CNY Exchange Rate Index followed a similar direction.

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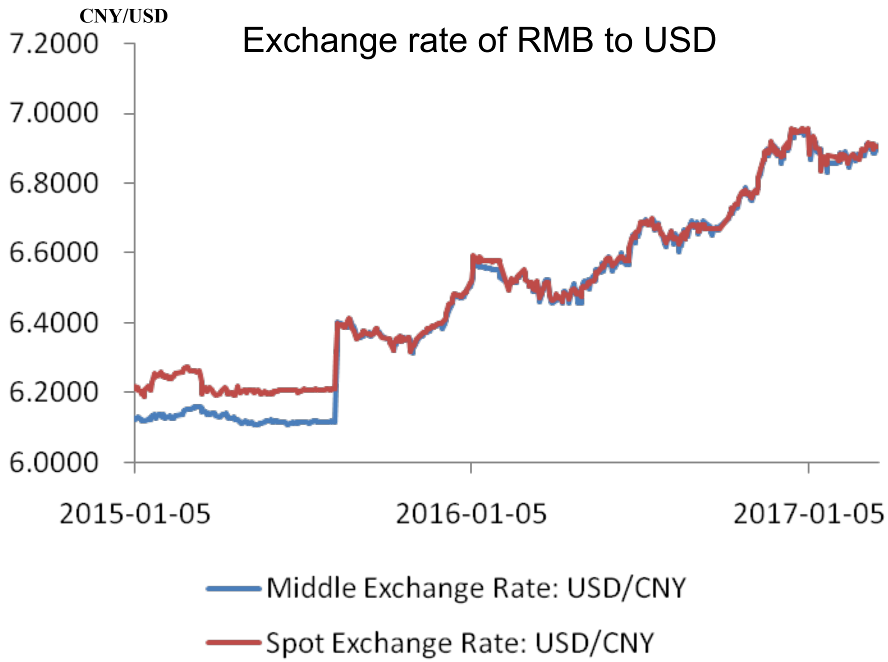
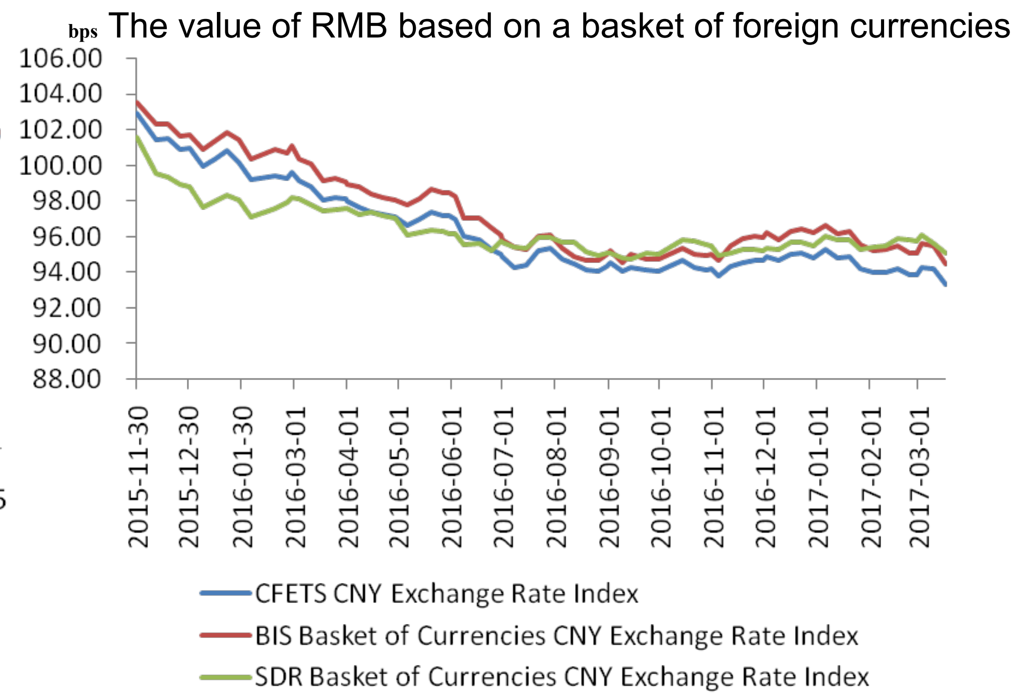
The same conclusion applies to RMB to USD and Basket rates

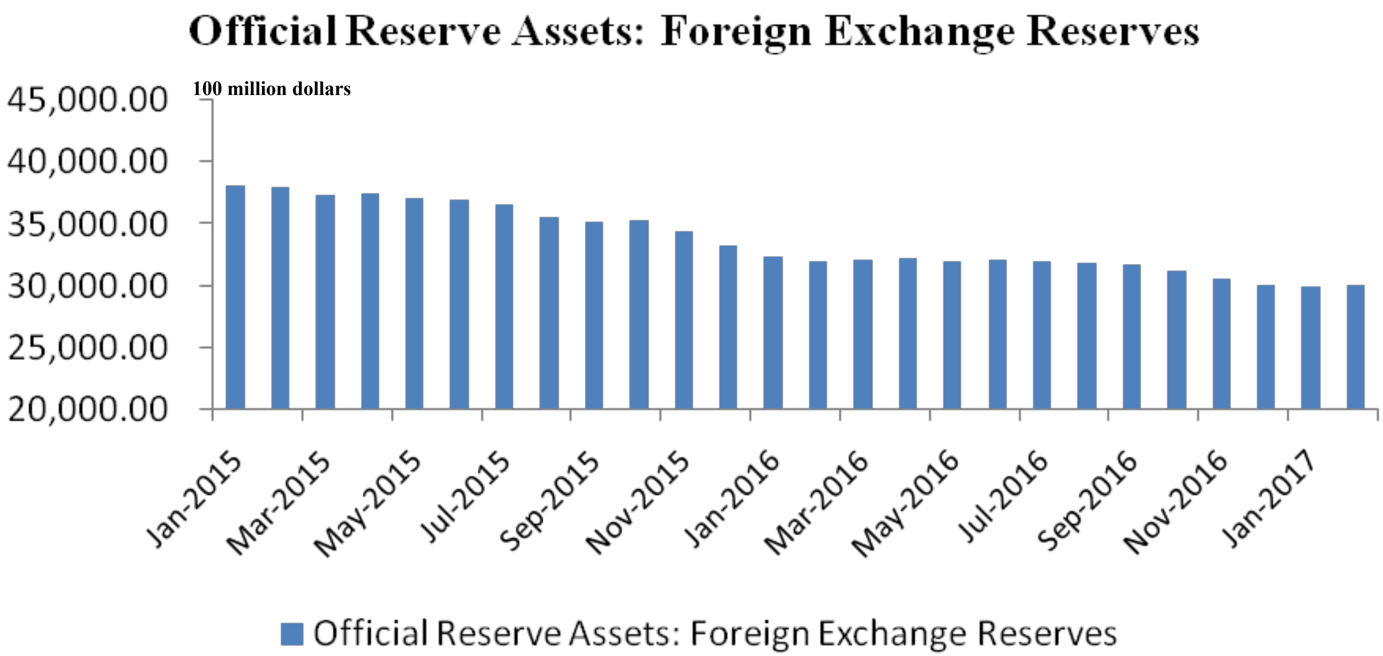




Overview

- The H2 2016 saw larger fluctuations in the RMB exchange rate, partially due to surging overseas investments.
- Expecting Fed interest rate hike, RMB depreciation pressure went up at the end of last year.
- Since 2017, the depreciation pressure on RMB to USD relaxed.

Foreign exchange reserve has contracted but remains abundant



Overview

- Foreign exchange reserve contracted from near $4 trillion to the current level of around $3 trillion during the past 3 years.
- However, foreign exchange reserve increased by $6.9 billion to $3.005 trillion during the month of Feb 2017.

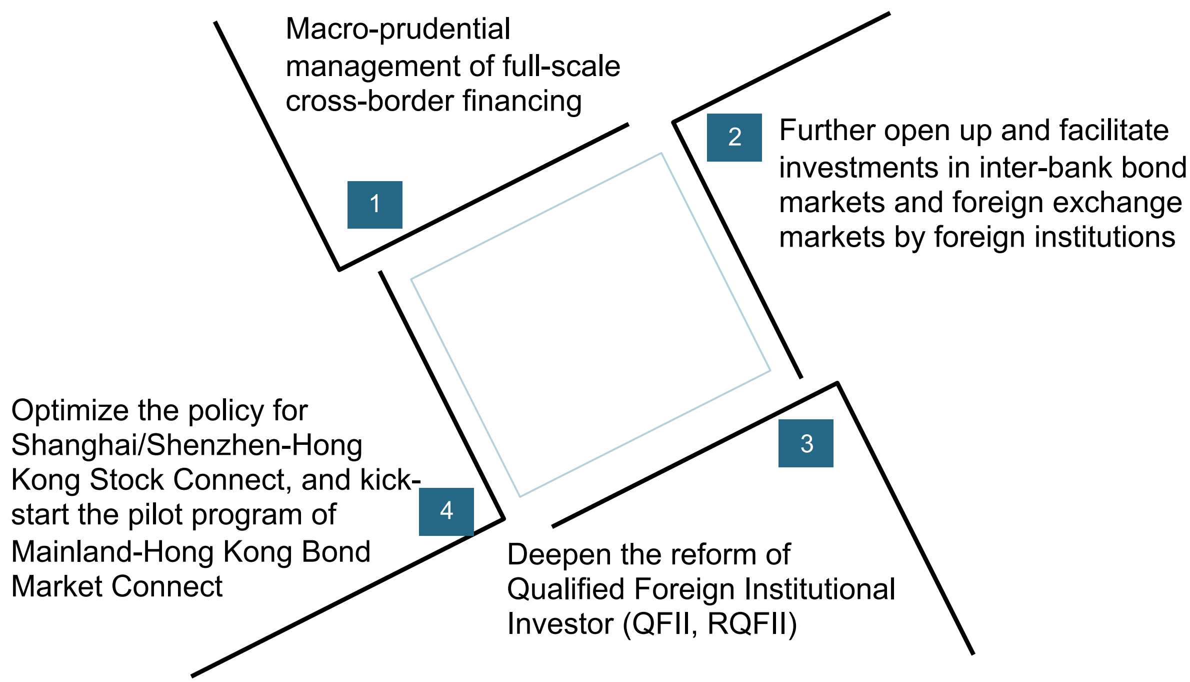
No evidence of fundamental changes implying significant RMB depreciation

- Foreign exchange market is sensitive to domestic and international economic events, thus exchange rate fluctuations are normal.
- There is no evidence of fundamental changes implying significant RMB depreciation, given that:
  - GDP stays within a reasonable range
  - CA continues to be on the surplus side
  - Forex reserve remains abundant, and
  - Margins between domestic and international asset returns are positive.

The RMB exchange rate regime will be more market-oriented

- We apply a managed floating RMB exchange rate regime based on market supply and demand, with reference to a basket of currencies.
- The regime will be further improved to allow market to play a greater role, and enhance two-way flexibility.
- The convertibility of capital account will be persistently improved. Existing examples include portfolio investment mechanisms under QFII, QDII, RQFII, and RQDII.
- **"Our Opened Window Won't Be Closed Anymore"**: liberalization and opening-up of the financial markets will be much further pushed forward.

Much wider access available ahead for overseas investors



- In Feb 2017, China opened its interbank FX market to overseas investors to allow hedging of bond positions.
- Foreign institutions that invest in the interbank bond market can trade products including forwards, swaps, cross-currency swaps and options with domestic settlement agents.

Cross-border capital flow management follows clear goals and widely-understood implementation measures

- Cross-border capital flow management goals:
  - Capital flow disorder prevention
  - FX market stability maintenance
  - Favorable reform & open-up market environment creation.
- Existing implementation measures:
  - Clear and non-discriminatory guidelines in macro-prudential management (e.g.: early warning reference concerning multi-national conglomerate fund pool business)
  - Strict and guideline-based cross-border transaction scrutiny
  - Enhanced payment and settlement compliance requirements
  - Anti-money laundering
  - Industry-specific guidelines to curb blind investment, overcapacity and leverage pileup.

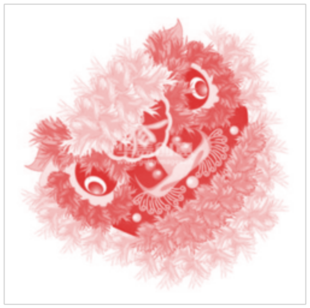
Recent Developments in cross-border capital management

Refine the macro-prudential administration of cross-border capital flows

- Refine the early warning and response mechanism for cross-border capital flows
- Diversify the toolkit for macro-prudential administration of cross-border capital flows

Enhance the ongoing and ex-post micro regulation of markets

- Improve authentic filing of cross-border receipts and payments by market players
- Intensify commercial banks' authenticity and compliance reviews on foreign exchange businesses
- Strengthen obligations of anti-money laundering, tax avoidance prevention and counter terrorism financing
- Upgrade crackdowns on irregularities
- Build an administration framework featuring government regulation and market self-discipline

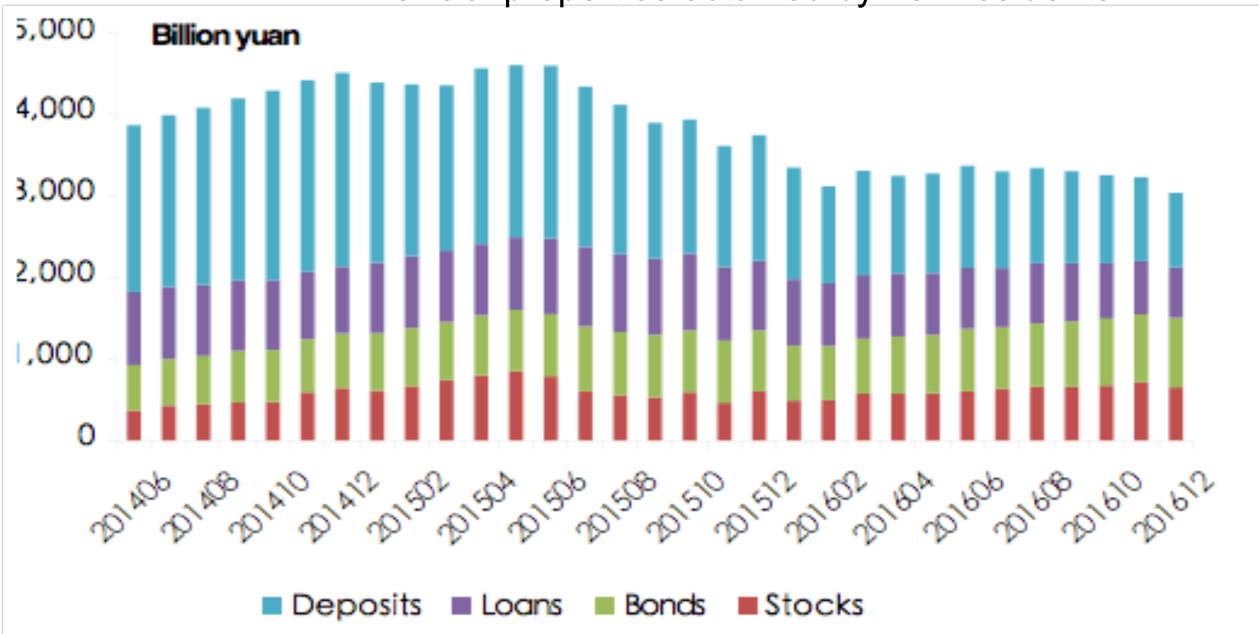


RMB as a reserve currency

- Various channels and products available for foreign investors to hold RMB financial assets
- Domestic bonds held by non-residents expanding
- China’s domestic RMB financial property yields remain attractive
- Market depth, liquidity and infrastructures improving significantly
- No limitation on investment quota, financial instrument selection, and cross-border fund transfers for any central bank investor and alike
- Various facilities set up and preferential treatments established to further promote overseas investors participation in Chinese financial markets

Domestic bonds held by non-residents expanding though the aggregate RMB financial properties obtained by overseas investors declined

RMB financial properties obtained by non-residents



Overview

- By the end of 2016, non-residents possessed RMB 3.03 trillion yuan of RMB financial assets, which decreased significantly from its peak of around 4.6 trillion.
- In the mean time, bonds held by overseas investors expanded gradually to its current level of around RMB 830 billion yuan ($120 billion).

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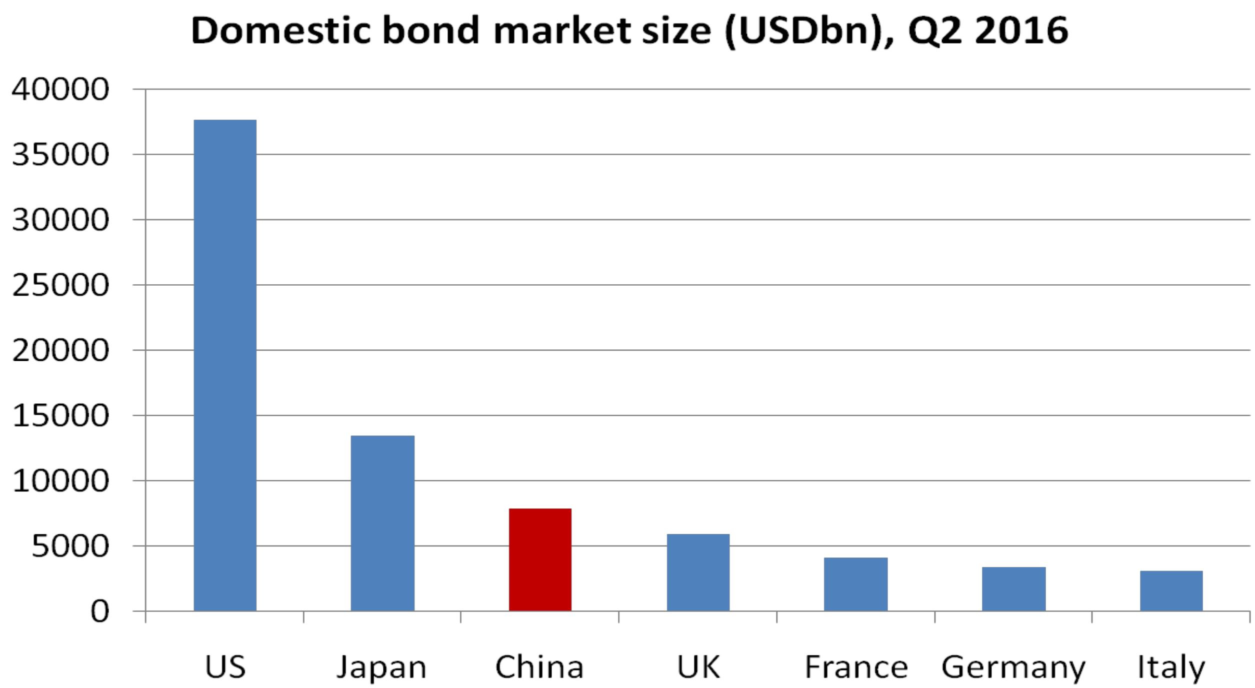
Foreign investors participation quite limited though China has the 3rd largest bond market in the world

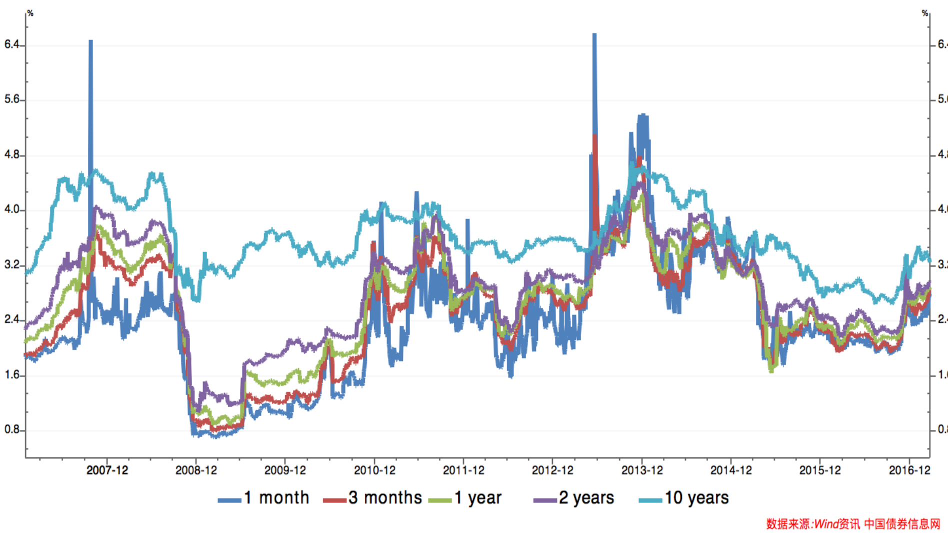


Overview

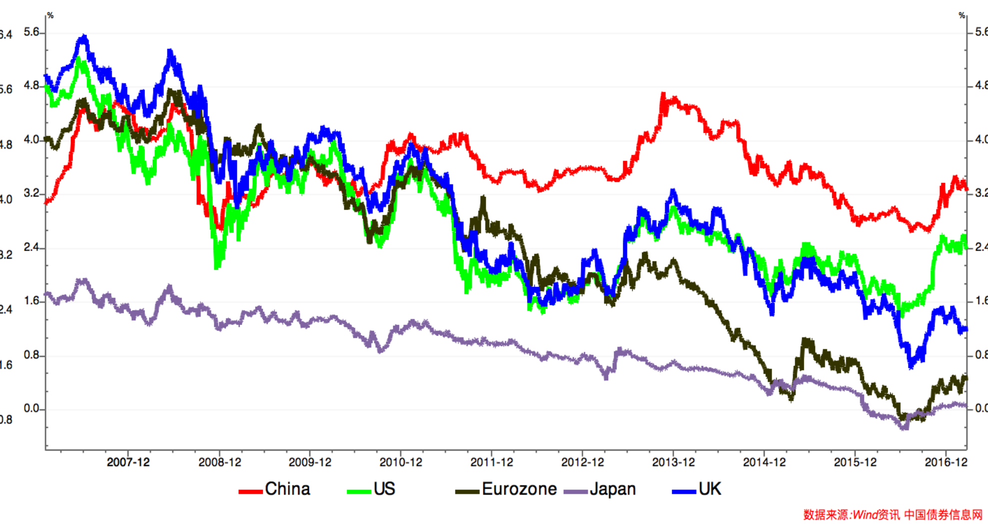
- By the end of 2016, less than 2% of Chinese bonds is hold by foreign investors.
- The ratio stands at around 20% for the developed economies and 10% for the emerging markets.

Government bond yields remain attractive among major countries

Chinese Government Bond Yields



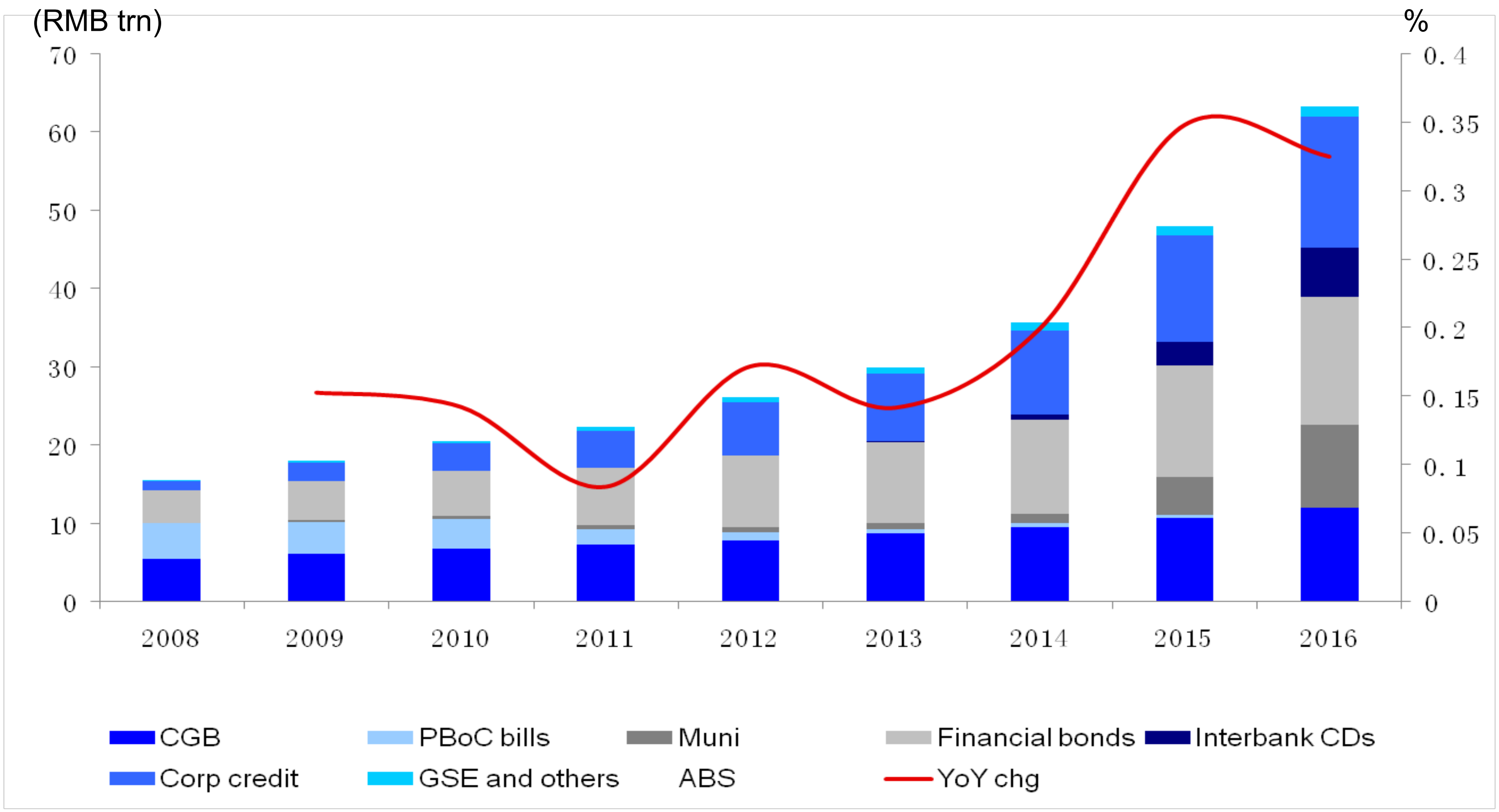
10-year Government Bond Yields



Overview

- The level of Chinese government bond yields showed upward trends since H2 2016.
- Among the major countries, Chinese 10-year bond yields have been the highest since 2010.

China's domestic bond market widening and deepening significantly



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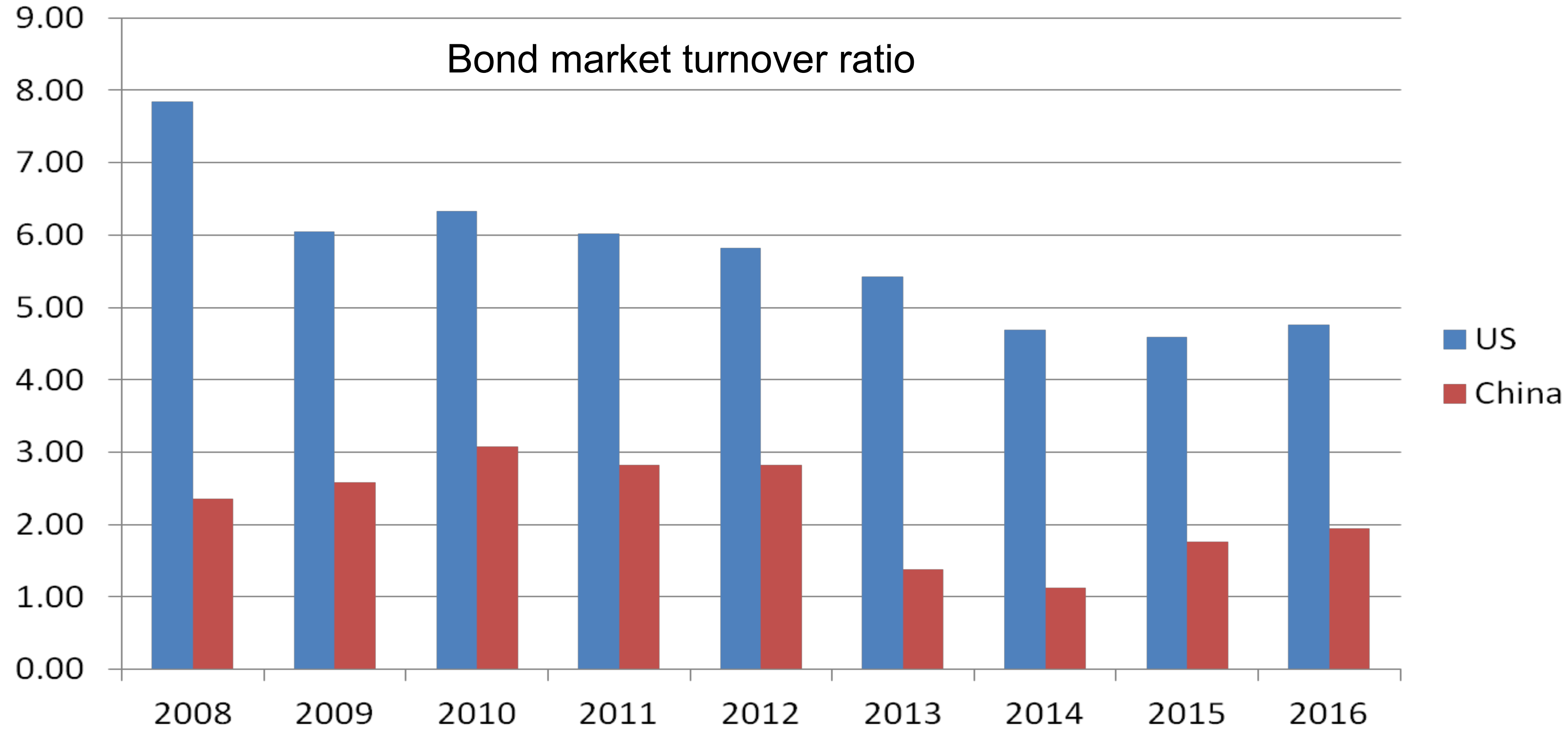
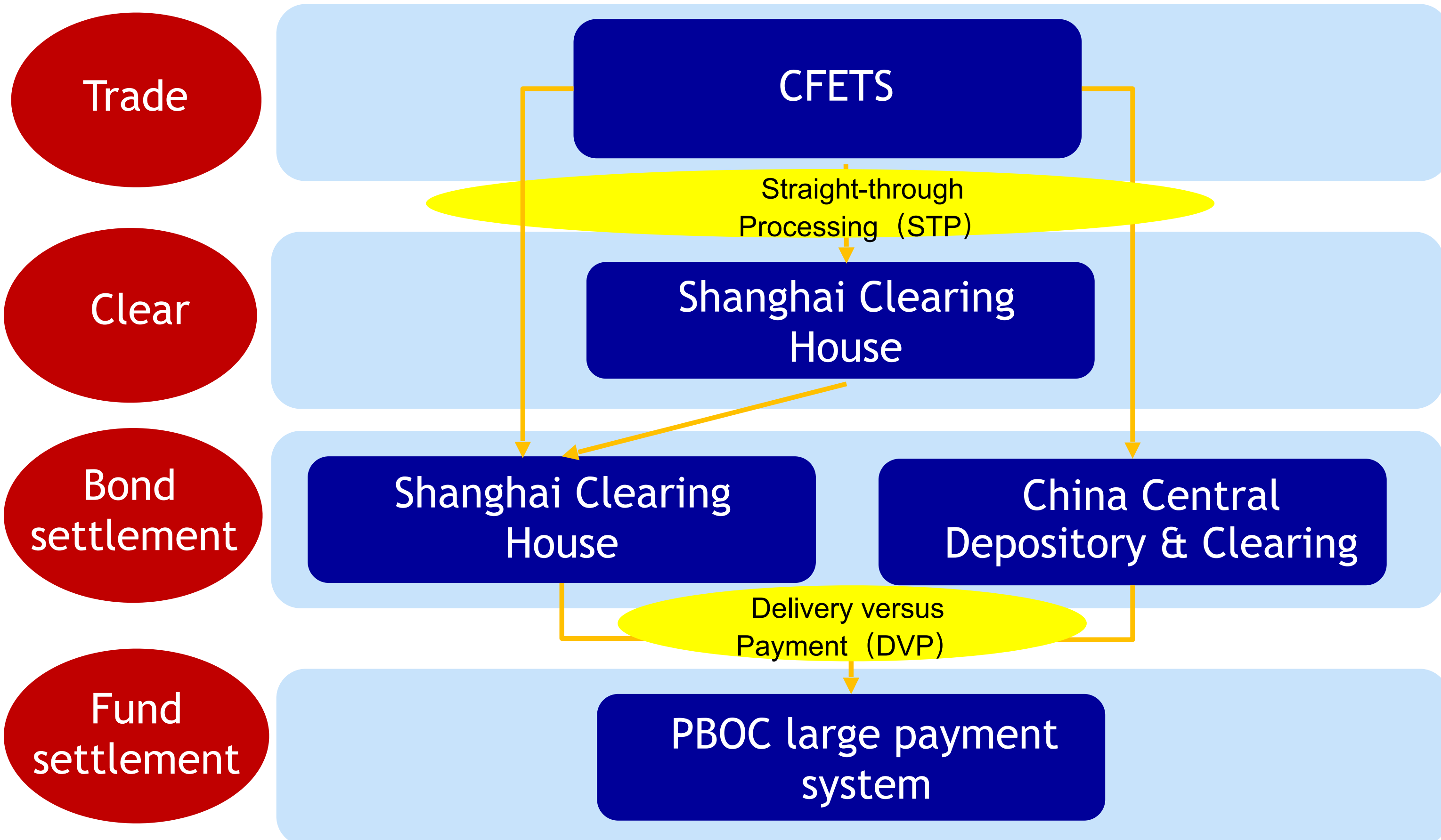
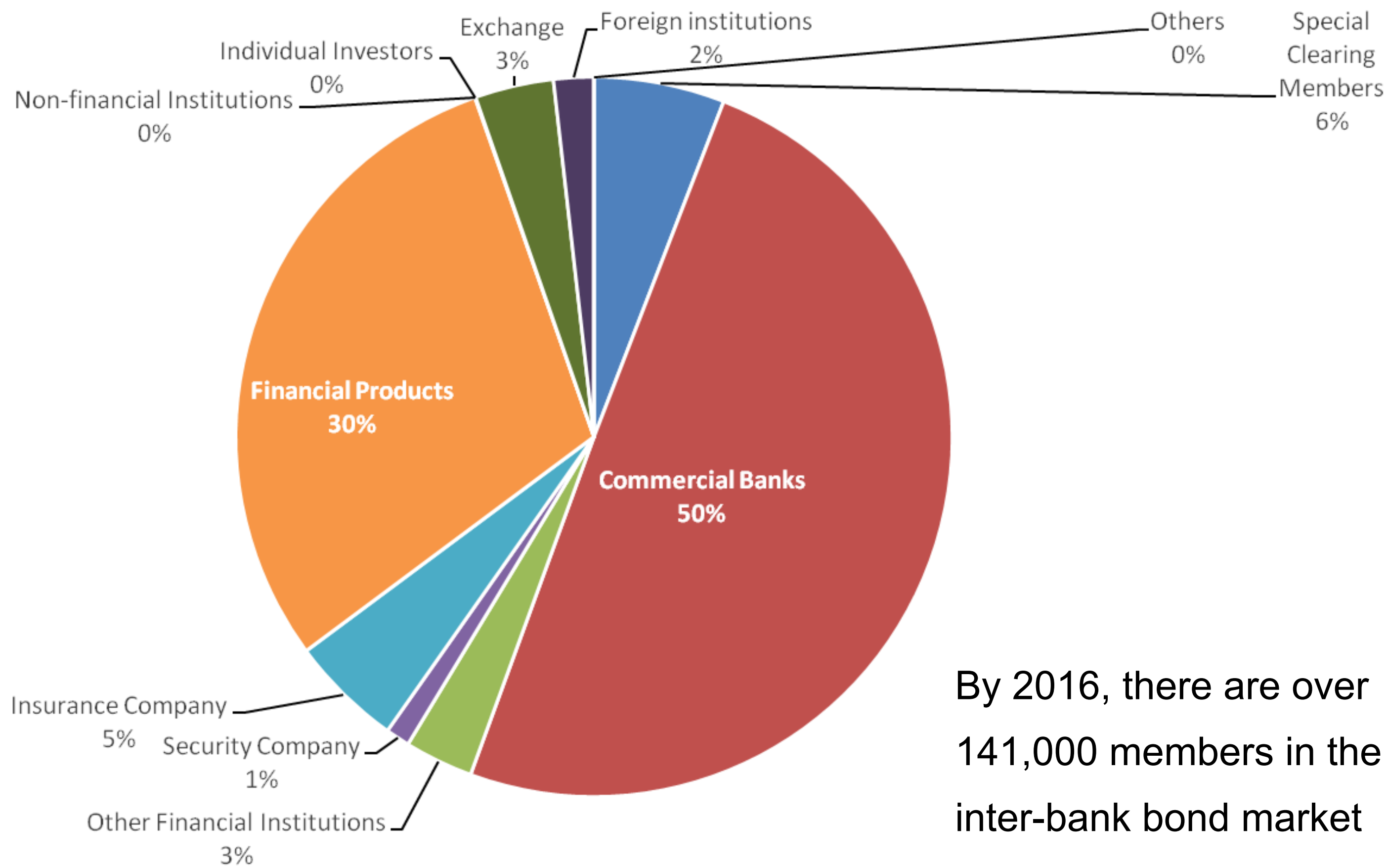
Market liquidity improving since 2014



Infrastructure and supporting systems fully established and well functioning



Participants and various investors diversified with a huge membership



By 2016, there are over 141,000 members in the inter-bank bond market

Foreign investors eagerly entering the Chinese bond market

By the end of 2016	
Number of institutional investors	407
— foreign central banks and similar institutions	58
Bond investment balance	800 billion yuan
During 2016	
Increased number of institutional investors	105
— foreign central banks and similar institutions	17
Increased balance of bonds investment	150 billion yuan

Various channels available for foreign central banks and similar institutions to hold RMB assets

- Channels:
  - —QFII
  - —RQFII
  - —CIBM
  - —Offshore market
  - —Others
- According to incomplete statistics, by the end of December 2015, foreign central banks or monetary authorities held around RMB 864.70 billion of RMB-denominated assets, including
  - —bonds
  - —stocks
  - —deposits
  - —other financial products

All existing products eligible for foreign central bank and similar institutions to invest in China's interbank bond & FX market

- All instruments existing in the interbank

fixed income market:

—cash bond
—bond repo
—bond lending
—bond forward
—interest rate swap
—forward rate agreement
—inter bank lending and others

and FX market:

—spot
—forwards
—swaps
—cross-currency swaps
—options

- No quota control, no limitation on fund transfer, given related to bond investment.
- Either NAFMII Master Agreement or ISDA Master Agreement is acceptable.
- In addition to investing directly, overseas investors can either entrust the PBoC or eligible commercial banks as agents to do investments.

Additional efforts pushing forward to improve access to CIBM for overseas Investors

- Income tax and VAT treatments on overseas bond investors

	Income Tax		VAT	
	Capital Gain	Interest	Capital Gain	Interest
CGBs & Municipals	Exempt	Exempt	Exempt	Exempt
Other Bonds	Exempt	10%	Exempt	6%

- Exploring options to extend CIBM trading hours and settlement dates

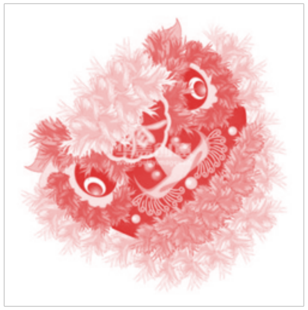
— evaluating options to extend CIBM trading hours to allow day time trading by European and US investors

— working on extending settlement dates, so as to facilitate liquidity management requirement of overseas investors

- Further improve market access via international collaboration of market infrastructure

— exploring options for international collaborations on market infrastructure, including custodian, clearing and settlement services, in order to avoid/reduce investor burden on account opening and to improve convenience for trading

— Mainland-Hong Kong bond market connect is on schedule for kickoff



Thank you!

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