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Japan-China Financial Cooperation and its Prospects for the Tokyo Market

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There is an increased opportunity for the resumption of financial cooperation between Japan and China induced by the realization of a bilateral summit between the leaders of the two nations last November. Previously, Japan and China had engaged in a pioneering effort to establish full-fledged direct exchange markets between the Japanese Yen (JPY) and the Chinese Renminbi (RMB), but discussions were brought to a standstill by the territorial dispute over the Senkaku Islands (known as the "Diaoyu Islands" in China). In accordance with the progressing internalization of RMB, moves like the establishment of RMB clearing banks is accelerating worldwide, but Japan appears to be trailing in the wake of other countries in this area. This article considers the issues involved in promoting financial cooperation between Japan and China in light of the bilateral summit and in activating RMB business in the Tokyo market.

Background of Financial Cooperation between Japan and China

In December 2011, then-Japanese Prime Minister Yoshihiko Noda and former Chinese Prime Minister Wen Jiabao agreed to the "Financial Cooperation between Japan and China" through a bilateral summit in Beijing to enhance mutual cooperation in the financial markets of both countries in the context of growing economic and financial ties between the two nations. The agreement advocated close cooperation across a wide range of fields in the financial markets and made specific provision for the following four points: (1) promoting the use of JPY and RMB in cross-border transactions between Japan and China, (2) supporting the development of direct exchange markets between JPY and RMB, (3) supporting the sound development of JPY and RMB bond markets, and (4) encouraging the private sector to develop JPY- and RMB-denominated financial products and services in overseas markets, in addition to establishing a joint working group[1].

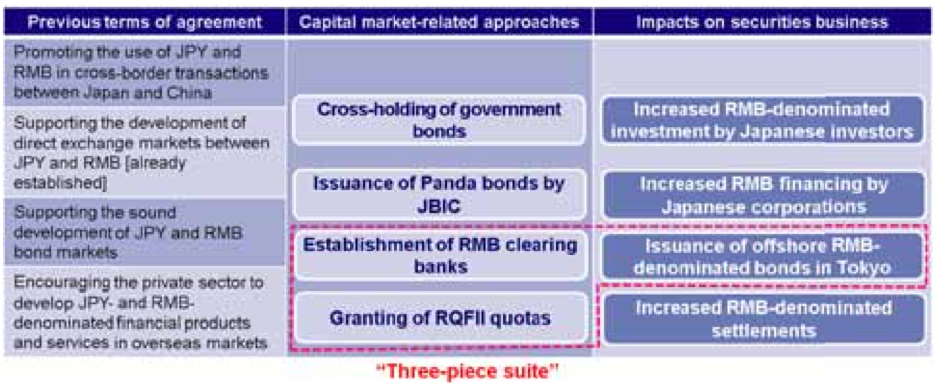
[1] "Enhanced Cooperation for Financial Market Development between Japan and China (Fact Sheet)," Ministry of Finance (2011)

The second point in the aforementioned agreement, the establishment of direct exchange markets for JPY and RMB, should be highlighted as the main achievement of financial cooperation between Japan and China. Direct exchange between JPY and RMB without using an intermediate currency was commenced in June 2012, thereby establishing direct exchange markets for the two currencies[2].

The framework for direct JPY-RMB transaction was designed to facilitate bilateral settlements, lower transaction costs or increase the volume of offshore RMB business in the Tokyo market, while for China the aim was also to eliminate its excessive dependence on the U.S. dollar (USD). In addition, following the pioneering move of Japan as the first nation to commence direct currency trading with China, direct exchange markets have been expanded between RMB and the Australian dollar (AUD), the New Zealand dollar (NZD) and the British pound (GBP), testifying to Japan's foresight.

The financial cooperation between Japan and China also envisages other moves as the cross-holding of government bonds and the issuance of Panda bonds[3] by the Japan Bank for International Cooperation (JBIC). In terms of the corollary of this financial cooperation between the two nations, an increase in economic relations between Japan and China, an increase in RMB-denominated investment by Japanese investors and RMB financing by Japanese corporations, an increase in the volume of RMB settlements in Tokyo, and positive impacts on securities business, etc., were anticipated (Fig. 1). However, as bilateral relations between Japan and China soured following the nationalization of the Senkaku Islands by the Japanese government in September 2012, further movements to strengthen financial cooperation has practically hit the rock.

Fig 1: Financial cooperation and capital market & securities business between Japan and China



Source: Compiled by Mizuho bank, Ltd.

[2] "Direct JPY-RMB trading in Tokyo aims to facilitate trade and settlements between Japan and China and to achieve precedence among offshore RMB markets," Nihon Keizai Shimbun, May 27, 2012 (in Japanese)

[3] Panda bonds refer to bonds issued by non-Chinese residents in mainland China. Panda bonds has been issued by International Finance Cooperation (IFC) and the Asian Development Bank (ADB), and in last March Daimler became the first non-financial corporation to issue Panda bonds.

Internationalization of RMB and progress of the introduction of the "three-piece suite"

While financial cooperation between Japan and China is at a standstill, countries around the world is presenting a positive stance towards the internationalization of RMB.

The easing of restrictions on RMB transactions and the resulting increased use of RMB in cross-border settlements has led to a worldwide accumulation of offshore RMB. Several sizable offshore markets for RMB has already been formulated, starting from (i) the embryonic status of Hong Kong as an offshore RMB center, followed by (ii) the expansion to London, Taiwan and Singapore, etc., and has come to a stage where (iii) expectations that RMB will come into use as a currency for worldwide payments.

The Chinese government is also pushing for RMB internationalization. Following President Xi Jinping's visit to Europe last March, there has been a trend of increased establishment of RMB clearing banks and the granting of quotas under the RQFII (Renminbi Qualified Foreign Institutional Investor) program. The issuance of offshore RMB bonds, led by the local branches of Chinese banks, is also flourishing. In this article, this combination of the establishment of RMB clearing banks, the granting of RQFII quotas and the issuance of offshore RMB bonds is referred to as the "three-piece suite."

Under the current background of intensified competition among financial markets led by the developed nations, the introduction of the "three-piece suite" is likely to become an important competitive power for the world's financial centers as an effort to catch up with the increased importance of RMB in international financial business(Fig. 2). It is also expected to gain recognition as a strategy for growth in global financial business in China's financial industry and as a milestone for the cooperative "One Belt and One Road" vision.

Turning to Japan, its emergence as the "number one international financial and capital market in Asia" is being advocated under the "Japan Revitalization Strategy," one of the three arrows upon which the so-called "Abenomics" is based. Amid such circumstances, it is without question that in the context of the resumption of financial cooperation between Japan and China, it is an urgent issue for Japan to introduce the "three-piece suit" to the Tokyo market to draw level with the other markets. Then, how should the introduction of the "three-piece suite" to the Tokyo market be considered?.

Fig 2: Current situation of the introduction of the “three-piece suite”

	Clearing bank	Established	RQFII quota (RMB)	Major listed RMB bonds
Hong Kong [Dim Sum bonds]	BOC	Jul. 2009	270 billion	(1) China Development Bank (2007), (2) Chinese government bonds (2008 onwards), (3) McDonalds, Caterpillar (2010), (4) Orix Corporation (2011; the first Japanese corporation to issue)
Taipei [Formosa bonds]	BOC	Jan. 2013	100 billion	(1) CTBC Bank (first issuer; 2013), (2) Deutsche Bank (2013), (3) major Chinese state-owned banks (2013)
Singapore [Lion City bonds]	ICBC	Feb. 2013	50 billion	(1) HSBC, SCB (first issuers; 2013), (2) DBS/UOB (2013), (3) ICBC (2013), (4) ICBC (double-listed in Taiwan; 2014)
London	CCB	Jun. 2014	80 billion	(1) HSBC (first issuer; 2012), (2) CCB subsidiary (the first Chinese corporation to issue; 2012), (3) UK government bonds (2014), (4) CDB (2014)
Frankfurt [Rhine bonds]	BOC	Jun. 2014	80 billion	(1) KFW (first issuer, 2014), (2) ABC/CCB (2014)
Seoul	BOCOM	Jul. 2014	80 billion	(1) Woori Bank (first issuer, 2014), (2) ICBC ASIA (2014)
Paris [Arc de Triomphe bonds]	BOC	Sep. 2014	80 billion	(1) BOC (first issuer; double-listed in Frankfurt; 2014)
Luxembourg [Schengen bonds]	ICBC	Sep. 2014	N/A	(1) BOC (first issuer; 2014)
Sydney	ICBC	Nov. 2014	50 billion	(1) CCB/BOCOM/ICBC (first issuer; 2014)
Switzerland	None	-	50 billion	(1) CCB subsidiary (first issuer; 2014)
Dubai	None	-	30 billion	(1) ABC (first issuer; 2014)
Qatar	ICBC	Nov. 2014	30 billion	-
Toronto	ICBC	Nov. 2014	50 billion	-
Bangkok	ICBC	Jan. 2015	-	-
Kuala Lumpur	BOC	Jan. 2015	-	-

Source: Compiled by Mizuho Bank, Ltd.

The RMB clearing bank and RQFII in the Tokyo market

First of all, some consideration need to be made on a RMB clearing bank and RQFII.

The RMB clearing bank controls RMB settlements in a local market. Banks that handle RMB transactions are required to open accounts with the RMB clearing bank, and the settlement of RMB funds ultimately involve the transfer of funds between accounts in the RMB clearing bank. The RMB clearing bank also plays a key role in supplying funds and ensuring that settlements are processed smoothly when RMB liquidity dries up, and functions as a point of contact for mainland China related RMB transactions. In general terms, the RMB clearing bank serves as an intermediary in facilitating offshore RMB settlements.

The Tokyo market differs from its European counterparts in that it has only one hour of time difference from Hong Kong, the ample offshore RMB pool, which could contribute to a certain level to smoothened offshore RMB settlements through collaboration with the Hong Kong market. In other words, the establishment of an RMB clearing bank in the Tokyo market would principally serve as a symbol of Japan's commitment to RMB-related business rather than just to facilitate transactions.

The RQFII program, meanwhile, is a scheme for RMB denominated foreign investment to mainland China. China's capital controls effectively prevent foreign investors from free investments to capital markets in mainland China, but there are two schemes that enable foreign investors to access China's onshore markets: the QFII (Qualified Foreign Institutional Investor) scheme and the RQFII. Given the foreign exchange risk resulting from the designated investment currency (principally USD for QFII and RMB for RQFII) and the restrictions on the portfolio allocation (no less than 50% of total capital should be invested in equity for QFII), the RQFII scheme seems to be more advantageous for investors. Intention to invest in mainland China markets is expected to grow in response to lowered interest rates and the maturity of financial markets in the developed nations. The Japan Revitalization Strategy emphasizes the need for efforts to strengthen asset management business in the Tokyo market, and therefore obtaining RFQII quota must be regarded as a priority in terms of inter-market competition. Currently, Hong Kong serves as the center for global RFQII investment, but in Asia Singapore and South Korea have also secured sizable RFQII quotas approved (Fig. 3). Given these situations, a proactive response from the Tokyo market seems to be called for.

Fig 3: Approved RFQII quotas

(RMB)	RFQII quota granted	RQFII quota approved
Hong Kong	270 billion	270 billion
Singapore	50 billion	18.6 billion
U.K.	80 billion	12.2 billion
France	80 billion	6 billion
South Korea	80 billion	17 billion
Germany	80 billion	6 billion

Source: Compiled by Mizuho Bank, Ltd., from the State Administration of Foreign Exchange data (March 26, 2015)

Issuance of offshore RMB bonds in the Tokyo market

This section examines the issuance of offshore RMB bonds in the Tokyo market[4].

In global capital markets, bonds denominated in various currencies are issued to meet the requirements of corporate issuers and investors. Offshore RMB bond markets have also witnessed geographical and quantitative

[4] "Japan to push for offshore yuan bonds," Nikkei Asian Review, December 30, 2014, http://asia.nikkei.com/Politics-Economy/International-Relations/Japan-to-push-for-offshore-yuan-bonds

expansion since the first dim sum bond was issued in Hong Kong in 2007 as a result of the ongoing internationalization of RMB and the steady movement of the RMB exchange rate, and these bonds have become an effective means of RMB financing outside mainland China. Given this, the issuance of offshore RMB bonds in the Tokyo market will constitute an advantageous development in the future[5].

Some Japanese corporations such as a leasing company have already successfully issued dim sum bonds, and it is considered that there is a definite need for RMB financing. However, in terms of the actual issuance in the Tokyo market, investors and operational practices （including the system） are expected to become an issue.

For investors, the political tensions between Japan and China and the low interest rates of RMB as compared to high-yielding currencies such as the Brazilian real (BRL) mean that market sentiment in Japan toward RMB-denominated investment may not necessarily be positive. This could mean that the Tokyo market may struggle to absorb a large-scale RMB bond issuance on its own. On the other hand, forecasts point to increased investment in foreign currency-denominated bonds by Japanese investors driven by Japan's ultra-low interest rate environment. If the onshore and offshore RMB bond markets were to become sizable enough to merit ongoing investment as a result of (i) improvements in bilateral relations following the resumption of financial cooperation between Japan and China, etc., (ii) monetary easing in developed nations and (iii) renewed prospects for stable economic growth in China, it would likely generate increased opportunity for investment in RMB bonds and other RMB-denominated financial products.

The issues with the operational practice derive from the fact that Japan's markets are not geared to handle foreign currency-denominated financial products. JPY-denominated financial products are the mainstay of the Tokyo market, and the settlements made in respect to foreign currency - denominated financial products are, generally, executed through JPY equivalent. Therefore, to activate transactions of foreign currency - denominated financial products, including the issuance of offshore RMB bonds, operational practice for securities and fund settlements and so forth would definitely require some adjustment. Some degree of saleability could be assumed for offshore RMB bonds in the Tokyo market, but the proper structures must be established so as to achieve a balance between the convenience of investor and the operational practice. Another realistic option in the short term that would effectively circumvent the aforesaid problems of the Tokyo market would be to utilize the Eurobond framework for bond issuance (Fig. 4).

[5] With the exception of Chinese enterprises, which are subject to the Chinese regulatory authorities' supervision, in principle, no specific restrictions apply to the issuance of offshore RMB bonds insofar as such bonds are not brought in to mainland China. Where such bonds are brought in to mainland China, the Chinese subsidiary will be subject to exchange and capital controls, and in general terms, both the parent company and its Chinese subsidiary will need to communicate actively with the Chinese regulatory authorities when conducting business in mainland China.

Fig 4: Saleability of offshore RMB bonds

	(1)	(2)	(3)
Framework	Eurobonds		Domestic bonds
Applicable law	British law		Japanese law
Market	Euro market (+ Tokyo market)		Tokyo market
Investors	Foreign institutional investors Japanese institutional investors	Foreign institutional investors Professional investors in Japan	Japanese individual investors
Listing	London, etc.	TOKYO PRO-BOND Market	-
Securities settlements	ICSD (Euroclear, etc.)		NCSD (JASDEC)
Fund settlements	ICSD (Euroclear, etc.)		Clearing houses (banks)

Source: Compiled by Mizuho Bank, Ltd.

Conclusion

This article has reviewed the background of financial cooperation between Japan and China, and has explained the introduction of the “three-piece suite” and its feasibility in the Tokyo market as an issue relevant to the resumption of such cooperation given recent trends in RMB internationalization.

It is certain that government-level talks grounded in private-sector needs are essential to the introduction of the “three-piece suite.” Specifically, the political agenda over the coming months will need to be factored into the equation in respect to the establishment of RMB clearing banks and the granting of RQFII quotas, considering that the progress on the granting of RQFII quotas to various European countries only followed President Xi Jinping’s recent visit to Europe.

In a situation like this, although subject to saleability, the issuance of offshore RMB bonds in the Tokyo market seems to be feasible in the near future, given the absence of specific restrictions aside from those on the bringing in of funds raised through offshore bond into mainland China. Japan boasts the largest bond market in Asia, and the utilization of JPY 1,700 trillion of financial assets is a major theme of the Japan Revitalization Strategy. Given the global upsurge in RMB-denominated financial business, the resumption of financial cooperation between Japan and China is expected to serve as a litmus test for the activation and internationalization of the Tokyo market. Future development is yet to be seen.

*Please note that the views and opinions expressed herein are those of the author and do not necessarily reflect the views of Mizuho Bank, Ltd.

[Remarks] This report is a translation of the original report in Japanese published on May 1, 2015. In the event of any discrepancy, the original report in Japanese shall prevail.