Renminbi Internationalization:
Interaction between the Offshore Market and the Onshore Market

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Abstract: Promoting and encouraging the establishment of offshore markets overseas is a significant character in the process of RMB internationalization. Existence and development of offshore markets can provide a cushion for opening onshore capital account gradually. It can relieve the impact of sudden opening to domestic financial market. At the same time, it can provide overseas junctions for part of institutions and enterprises in onshore market to take the lead in the cross-border RMB business. So it is a practical choice for RMB internationalization. Nevertheless, Existence and development of the offshore market will increase the difficulty of regulating and controlling domestic currency if the onshore market cannot be effectively connected and co-developed with the offshore market. It might provide convenience for the international capital to exercise a harmful impact on the onshore market and bring about an uncertainty of RMB pricing right in the future. After the fully opening up of the onshore market, the two markets will integrate with each other and form a RMB market that provides global covered and 24-hour service. At that time, the boundary between original offshore and onshore RMB market will be more and more blurry and evolve into a collaborative relationship among financial centers which participate in RMB business.

Key word: RMB internationalization, offshore market, onshore market.

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In July 2009, the pilot of RMB settlement in cross-border trade deals marked a crucial step in RMB internationalization. Along with this, the RMB internationalization is becoming more and more deepening. As of April 2013, there are 160 countries do cash payment business with China and Hong Kong, China, and the average rate of payment in RMB has reached to 6%. There are 47 countries among them whose respective ratio of trade denominated in RMB exceed 10%. RMB stably has become the 13th large international payment currency\(^2\). At the same time, overseas holdings of RMB have reached to 1 trillion\(^3\), including Hong Kong’s RMB deposits at around 600 billion which is over 50% of total. For more than three years, RMB internationalisation has formed a pattern which takes the cross-border trade settlement as a breakthrough and RMB offshore business in Hong Kong and other financial centers as pillars. According to the international experience, such a development idea and operation mode is a new exploration for sovereign currencies going to internationalization. However, it should be realised that both the growth of the RMB settlement in the Cross-border trade and the prosperity of offshore RMB business are only the means of RMB internationalization, rather than the final goal. The tradeoff decision does not mean it can absolutely immune to the potential risks. If the onshore market cannot be effectively connected with the offshore market, the onshore market might be marginalized because of the excessive development of the offshore market. Therefore, it is very important to explore the deep relationship and seek a coordinated development way between the two markets. Under the major premise of supporting the development of RMB offshore financial centers represented by Hong Kong, how to take the advantage of the vigorous development of the RMB offshore markets? How to open up the onshore RMB market step by step? How to manage the potential risks of the onshore market rising from the development of offshore market? All

\(^2\) Data from the SWIFT press release, "47 Countries in the World with more than 10% Renminbi Payments in the Trade with China and Hong Kong", www.swift.com

\(^3\) Data from the Reuters report in March 4, 2013, http://cn.reuters.com/article/CNAnalysesNews/idCNCNE92302U20130304?sp=true
these issues have important practical significances as they are related with the realization of the RMB internationalization.

This article first explains why the offshore market development is a practical choice to promote RMB internationalization while the RMB has not fully opened. Secondly it points out the potential impact on the onshore market due to the development of the offshore market. In the final section, it analyzes imaginable changes of relations between offshore and onshore market after the RMB being fully convertible.

1. Establishment of offshore market is a pragmatic choice for RMB internationalization while the onshore market is not fully opened.

Exploring and developing the offshore RMB market is a practical and wise choice while the onshore market is not completely opened for the internationalization process of RMB. This is a strategic step for promoting capital account opening steadily, with the cross-border capital flows being kept basically stable and the reform of domestic financial system being promoted actively. The offshore market represented by Hong Kong becomes a link between onshore market and international market. On the one hand, it connects with the domestic onshore market, and on the other hand, it is in line with the international market. It can provide practice opportunities of participating in the international market for the domestic onshore agencies and play as a cushion for domestic onshore market to fully opened.

1.1. The RMB onshore market is a solid foundation of the offshore market.

First, the RMB cross-border trade settlement pilot business since July 2009 has provided a certain amount of RMB for the offshore RMB market, which has contributed to the rapid development of offshore RMB business. There will be an offshore market required to deal with relevant business when the quantity of
overseas RMB reaches to a certain scale of circulation. Hong Kong, London, Singapore and so on, have formed a certain scale of offshore RMB market respectively. Second, the onshore market is the foundation of the value of offshore RMB. Just as the foundation of the dollar's value is its purchasing power in the United States, the base of the RMB’s value is its purchasing power in the domestic market of China. Along with the development of the offshore market, offshore currency will be back and flow to the onshore market through certain conduits. The current offshore RMB is relatively limited on the investment channels and third party use. In addition, the interest rates and investment opportunities in domestic are remain attractive. Therefore, the holders of offshore RMB are keen for more RMB backflow channels can be established by China’s policy authority. In 2012, The State Council gave a permission to Qianhai, Shenzhen, which is an innovation experimental zone dealing with the offshore RMB business, to pilot cross-border loaning RMB and issue RMB bonds by domestic enterprises in Hong Kong. It will greatly promote the development of Hong Kong RMB offshore financial center as a new channel of RMB cross-border backflow was established.

1.2. The offshore market can provide a cushion for opening onshore capital account gradually.

Sudden opening of the onshore market will no doubt cause a big bang to the domestic financial system. The process of fully opening the onshore market needs to deal with step by step for China who has not yet disentangled from its domestic twisted financial system. In the development process of offshore markets, there is no need for a sovereign currency to be freely convertible immediately, and the control of capital account can be dismissed orderly and gradually with the reform of the onshore financial system. For emerging market countries which are interested in internationalizing its currency, the offshore market can help to increase the recognition and acceptance of the currency

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while still allowing the authorities to retain a measure of control over the pace of capital account liberalisation. It provides a useful cushion for the RMB internationalization while the capital account has not yet fully opened. For example, Hong Kong offshore market’s size is small and it’s separated with the domestic onshore market, so the RMB backflow from Hong Kong’s offshore market will not affect the onshore market too much nowadays and in the future. Similarly, the exchange rate in offshore market will not affect that of onshore market much. So it needn’t to worry about that the onshore market price or the domestic macro-control will be disturbed. The authority should take the offshore market as a cushion to isolate the risk and a bridgehead to carry out the strategy of national financial development, thus to promote the process of RMB internationalization.

1.3. The existence and development of offshore market can provide overseas junctions for a few institutions and enterprises to take the lead in dealing with RMB cross-border business.

The existence and development of the offshore market provide a platform for gradually opening the capital and financial item. It makes part of the onshore market institutions and enterprises can take the lead in entering the international RMB market and accumulate experience in facing global trading rivals and exchange rate floating freely. Along with the formation and development of offshore RMB market, especially in Hong Kong, the step of connecting onshore and offshore market has been accelerated. After cross-border RMB trade settlement starting, the RMB ODI (Overseas Direct Investment) and RMB FDI (Foreign Direct Investment) both have been started. China’s governments, financial institutions and enterprises are allowed to issue RMB bonds in the

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9 In genera, there is no regulation in offshore market, so the exchange rate in it is freely floating based on market supply and demand.
offshore market, three kinds of overseas institutions are allowed to invest RMB in the domestic interbank bond market. In December 2011, the official opening of the RQFII (RMB Qualified Foreign Institutional Investor) further speeded up the opening of the securities investment. Moreover, the establishment of the Qianhai, Shenzhen innovation experimental zone opened the door for the cross-border RMB loaning business.

Predictably, the breakthrough of offshore and onshore RMB markets will be earlier than the overall opening of onshore market. More and more domestic institutions and enterprises can try to practice RMB cross-border business through the offshore RMB market, and consequently be prepared for dealing with totally opening of capital account as well as the RMB internationalization.

In addition, the RMB offshore market also can play a certain improving role for China financial system reform, especially for the liberalization of interest rate and more flexible exchange rate formation mechanism. Because there are no restrictions on the RMB in most of the offshore market, the interest rate and exchange rate of RMB formed in the offshore market basically reflect the real supply and demand of the market. There is certain reference for the onshore market-oriented reform of interest rate and adjustment of exchange rate formation mechanism. Recently, the gap at the spot exchange rate between the two markets once was narrowed to under 10 bp. It shows that China’s reform of exchange rate formation mechanism is productive.

Since 2009, Hong Kong RMB offshore market has been booming, and that in London, Singapore, Taiwan and other international financial centers also has made great progress. In March 2013, the total of RMB deposit and certificates in Hong Kong has exceeded 810 billion Yuan. Taiwan ranked 4 in stock of RMB also has RMB deposits around 50 billion. The formation and development of all these RMB offshore markets will further improve the offshore RMB liquidity and trading scale, consequently increase the overseas RMB vitality and the RMB international influence and push forward the RMB internationalization.
From the development history of all the main international currencies, the formation and development of most of them are more or less relied on the support of offshore business. For example, JOM (Japanese Offshore Market) has played an important role in the process of yen internationalization. Predictably, the development of the RMB offshore market also can help in some way for the RMB internationalization and the further opening of onshore market.

2. The Potential Impact on the Onshore Market from the Development of Offshore Market

Although as mentioned above that the development of the offshore RMB market is advantageous to the opening of onshore market, it may also bring some risks. Some scholars believe that the enthusiasm of using RMB to settle comes from huge arbitrage space. Arbitrage of exchange rate and arbitrage of interest rate will maintain in quite a long time because the gap of exchange rate between CNH and CNY cannot eliminate quickly. Although it shows a trend of decline recently, once dropped to below 10 bp, the abnormal surging of exporting from mainland China to Hong Kong in the first quarter of 2013 still shows that the arbitrage factor cannot be ignored. Some scholars think that Hong Kong's RMB offshore market development has a lot of confusion, and the current development does not coincide with the original intention in many aspects. How to appraise the function of the offshore market? In our opinion, in the long run, the rapid development of the offshore RMB market may also bring some unfavourable influences on the onshore market if the onshore market cannot be linked up effectively and co-developed with the offshore market. It will not only increase the management cost of the monetary authority, but also bring uncertainty to RMB pricing right in the future.

2.1. The broadening of the Offshore RMB backflow channels will increase the monetary control cost of the Central Bank

10 Yongding Yu(2011). The Internationalization of RMB must Proceed with Clear Goal and Step by Step[R]. Research Center of International Finance, Institute of World Economics and Politics, Chinese Academy of Social Sciences, 4 July.
The offshore money multiplier that is not controlled by the monetary authorities may cause interference with the onshore money multiplier along with the expanding of backflow channels. Offshore money multiplier often measures the maximum amount of commercial bank money in offshore market that can be created by a given unit of the initial offshore money. Just as the principle of onshore money multiplier, offshore money multiplier is roughly reciprocal of offshore reserve requirement ratio. As the offshore market often has less constraint, the deposit reserve requirement also is lower than that in domestic. Therefore, like domestic non-bank financial institutions, the presence of the offshore market may also reduce effective reserve requirement ratio, which is equivalent to increasing the credit multiplier\(^\text{12}\). If channels between onshore and offshore market are free enough, it is possible to interfere with onshore monetary policy through offshore money creation when the offshore money multiplier is greater than that of onshore market. Although, since a long time ago, RMB absorbed by Hong Kong commercial banks must be transfer deposited to the Shenzhen branch of the People’s Bank of China through the Bank of China (Hong Kong), which means that the actual reserve requirement ratio is 100% and there is basically no offshore money creation although there is no nominal deposit reserve rate. But, with the development of the trade finance business and the increasing market demand for derivatives, the actual RMB deposit reserve rate in Hong Kong have intrinsic demand for reducing. If the actual deposit reserve rate has decreased, the offshore money multiplier will increase. After the offshore currency has amplified effect, then it will impact on domestic monetary quantity control when it backflows to the onshore market through various channels. It can also cause disturbance to the domestic management of monetary policy although it does not have a great effect on the total amount in the early days due to the small amount.

Although the RMB backflow channels are limited and the pace of

broadening can be controlled by the monetary authorities, and overseas holdings of about 1 trillion RMB is too small to have a big impact on domestic market with 103 trillion RMB stock (M2), various kinds of "invisible" channels for RMB to backflow continue to be widen. What’s more, underground money transfer between Hong Kong and Shenzhen also has a considerable scale. In 2012, the Qianhai cross-border RMB loans and pilot of Hong Kong RMB bonds issued by domestic enterprises also provide new channels for the Hong Kong RMB backflow, though the amount of loan is still very low. Along with the further increasing of the offshore market scale and further broadening of RMB backflow channels, the speed and quantity of RMB backflows will gradually get rid of the control of central Bank. The independence of monetary policy will be affected and management costs will rise. It is more and more difficult for the central bank to monitor the speed and quantity of RMB backflow.

2.2. The offshore market might provide convenience for international capital to shock the onshore market

The development of the offshore market will create convenient conditions for international capital to impact a national currency. Under the foreign exchange control, international capital can't flows cross-border freely to impact RMB exchange rate. Nevertheless, along with the development of the offshore market and the increasing of offshore RMB funds, international capital is prone to indirectly impact the onshore RMB market because that it can obtain RMB from the offshore market fast and conveniently. If the onshore market cannot be effectively connected or co-developed with offshore market and the flowing of funds can't be effectively controlled between the two markets, especially between the domestic onshore account and artificial offshore account, the rapid development of the offshore market might make the local currency more vulnerable to the impact of international capital once the onshore market itself suffers from disasters, such as banking crisis, debt crisis, current account deterioration etc.. It is a typical case that the Thai baht suffered a huge shock

In fact, the capital account of Thailand in 1997 is not fully opened. Thailand's financial market became out of control due to the management between offshore business and local business was very chaotic. The open offshore market provided convenience for the international speculators to impact onshore market. As early as before the crisis, foreign speculators guide wide public opinion, and even rumour that the IMF has clear required baht to devaluate. At the same time there were a large number of foreign funds borrowed Thailand baht from local banks through offshore business and organized sudden attack in exchange market covertly by selling Thai baht and buying dollars through foreign exchange forwards, swaps and interest rate swap transactions. Thailand's central bank did not detect timely and prevent effectively. Under the lax supervision environment, Thailand's own banks borrowed large sums of money from overseas without restraint, invested these short foreign loans in domestic long-term project and thus caused enormous risk in exchange rate and liquidity. At the end of June 1997, Thailand lost the ability to continue to intervene in currency markets due to that its reserves fell by $30 billion. On July 2 1997, the Thai government was forced to renounce to give up the pegged exchange rate regime, and implement a managed floating exchange rate system. That very day the Thai baht devaluated more than 30% and once reached the lowest of 32.6 baht to 1 dollar\textsuperscript{13}.

2.3. Over-dependence on the offshore market can bring uncertainty to the future RMB pricing right

Because of the difference in legal environment, regulatory conditions and the tax system between the offshore and onshore market, a national currency will form different prices in the two markets. If capital controls are effective, the offshore and onshore market was divided from each other, both formed their respective interest rate and exchange rate, and the offshore market won't be a

challenge for onshore market to lose its pricing right. In addition, through arbitraging, the larger market can digest the influence of price change in relatively smaller market. In general, the scale of onshore market is often larger than that of the offshore market, thus ensures the onshore market can dominate the price discovery function. However, with respect to the capital controls and size of market, the challenges of losing pricing right for onshore market are increasing with the development of the offshore RMB market.

From the perspective of capital controls, the RMB capital account fully open is an unquestioned trend despite existing disputes on the timing and steps. Along with the development of the offshore RMB market, the formation of RMB outflow and backflow mechanism, the cross-border capital flows will increase and the links between offshore and onshore will be closer and closer. The offshore market price has begun to affect the onshore market price. It has been more and more impossible for monetary authorities to eliminate the challenges to the onshore market pricing right from the offshore market through capital controls. Empirical research shows that the connection between the onshore forwards market and offshore NDF market continuously strengthens after the reform of the RMB exchange rate system in 2005. The RMB future exchange rates with same maturity in domestic and overseas market become to influence each other. The changing tendency of the RMB NDF market rate will more lead the changing tendency of the RMB onshore forward market rate.

From the perspective of the size of the market, although the RMB stock is quite limited in the RMB offshore market, mature financial markets, such as Hong Kong, have a lot of financial tools with high leverage. Once the stock fund is allowed to invest in these tools, it is possible to make bigger deals leverage on smaller capitals. Together with the fewer regulation and lower transaction costs in the offshore market, there will be huge deals and increasing market risk. With the rapid development of the offshore market, the value

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discovery function of the offshore market will be exerted more and more. If the value discovery function of the onshore market remains inhibited by policy, the onshore market price is no more than an equilibrium formed by "policy + market" in the view of market participants compared with that of the offshore market. Over the long run, the pricing right of the RMB is likely to be eroded under the choice of freedom market.

Dollar history is a proof. Dollar is the world's main international reserve currency, but the international dollar syndicated loan interest rate pricing right is not in New York, but in London. One of the reasons for America’s loss of dollar interest rate pricing right is that the United States adopted a policy of interest rate control in the domestic market in the 20th century 60s and 70s while the dollar offshore market abroad developed rapidly. The development of Eurodollar market, especially London market is originated firstly from a large number of US dollars outputted by the Marshall Plan and lots of US dollar deposits hold by the Soviet bloc during the cold war. Except large amounts of dollars positions, loose regulatory environment is also a key reason for the Eurodollar market booming. After the Sterling Crisis, British government restricted pounds loans abroad. In order to maintain the status of London as an international financial centre, the British government created a looser regulatory and financial environment for dollars, which had played a positive role for the development of the Eurodollar market. However, profitability and competitiveness of the U.S. financial institutions, especially the banks, suffered severely from the implementation of financial regulations, control policies of interest rates and capital and restrictions on foreign companies to raise funds in the United States. So the U.S. Banks became to set up branches in London and

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15 “The bank interest rate in Europe is higher than that in the United States whose deposit rate of interest cannot to rise because of regulation Q in 1960s. The gap of interest rate between European and American banks induced a large number of dollar deposits to be transferred to Europe by European branches of American banks. During this period, the United States promulgated the 'Interest equal tax' which includes taxes on American investors who buy European bonds and stock, restrictions on commercial banks' overseas loans and American enterprises' foreign direct investment to limit the investment in Europe, and then in order to reduce the deficit in balance of payment. But capital controls had never prevented the outflow of capital and just had stimulated the development of European monetary market and bond market.” Yongding Yu (2012). The Period for the Strategy of Capital Account Liberalization Becomes Basically Ripe [J]. CAIJING, Apr., http://www.topcfo.net/index.php/News/index/id/24777.html.
a large number of international loans transferred to the London market\textsuperscript{16}, which contributed the London as the world's largest offshore dollar center\textsuperscript{17}. After dollar interest rate pricing right settled in London, international dollar syndicated loan interest rates are still referring to LIBOR even if that the U. S. had relaxed domestic interest rate controls. Similarly, the trading center of Japanese Yen stock futures is not in Tokyo, but in Singapore. The RMB interest rate and exchange rate pricing right, too, may settle in the overseas financial center if domestic onshore market is not co-developed with the offshore market.

If the RMB pricing right is not in Mainland China, then is most likely in Hong Kong. Of course it is also likely to settle in another RMB offshore market, such as in London or Singapore market and contributes to those international offshore financial centers. It is possible to provide convenience for the international capital to impact onshore market if the RMB pricing right won’t be settled in domestic market. Currency offshore center is the place in where financial giant can manipulate and speculate in market. If RMB pricing right controlled by the overseas international financial centers, it will increase greatly for the possibility and degree of future RMB impact by international capital. For example, in the current European debt crisis, most of countries like Greece whose bond trading center is not in domestic but in Frankfurt and London, and its secondary market pricing right is settled in the overseas financial market as well. The developed hedge mechanism in European offshore financial centers becomes one of the reasons for the excessive volatility of the treasury prices of these countries such as Greece. Although Europe has realized this problem and the European parliament passed a law of banning credit default swaps (CDS) "naked trading" and restricting "naked short" on November 15, 2011, the problems of vulnerability to shocks are not fully solved due to the lack of debt pricing right in these countries like Greece. So the settlement of RMB pricing

\textsuperscript{16} In 1966, money market interest rate in the United States is higher than deposit interest rate in it that combined with the seeking for higher returns by savers led to banks facing "disintermediation" phenomenon and being forced to rely on European monetary financing more and more, which bring about the further development of Eurodollar market.

\textsuperscript{17} In 1970s, the influx of petrodollars was an important opportunity for the development of Eurodollar market, which brought up a gold periodo for it to develop.
right either in domestic or in overseas is worth attention.

2.4. The rapid development of the offshore market might squeeze the developing space of the domestic financial center

The use of currency has network externalities. There might be an inertia result from the rapid development of the offshore market while the onshore market is restrained. Once there is a mature RMB market overseas formed, it is very hard to attract a lot of overseas trades to domestic even the onshore market is fully opened. For example, Sony Company set up its financial management company in Hong Kong to deal with RMB business in early 2011. Sony's financial management company is unlikely to move to the onshore financial centers such as Shanghai, Beijing or Shenzhen even the onshore market is fully opened in the future. Once a variety of RMB business is formed at mature trading markets in Hong Kong, Singapore and London where gathering enterprises and institutions overseas who want to engage in RMB business, the developing of the domestic financial centers in mainland of China will be likely fall into competitive disadvantages due to the first-mover advantage of the offshore market.

In addition, there is no consequent relationship between the internationalization and the financial center development given a currency\textsuperscript{18}. On the one hand, currency internationalization is not necessarily for development of international financial centers. On the other hand, even if a currency has realized internationalization, the international financial center related to this currency also is not necessary located in the place of issue. For example, after the launch of the Euro, its degree of internationalization has significantly increased. However, most of the euro cross-border business is in London, but not in the euro zone. Frankfurt in Germany is not a Euro international financial center. And Paris in France, neither. Although the internationalization process of RMB is not as same as that of the Euro and it does not represent that mainland China

will lose the opportunity to have RMB international financial centers in the process of RMB internationalization like the loss of Germany and France, there is a possibility.

Therefore, we must know the impact on the contribution of onshore financial centers from the development of the offshore RMB market; take advantage of RMB internationalization to speed up the development of onshore financial system. Otherwise, the onshore market may also be marginalized in the process of RMB internationalization. The onshore financial center is not naturally formed with the RMB internationalization although it will help to the development of the onshore financial centers.

3. Possible changes of the relationship between the RMB offshore and onshore market after the RMB fully convertible

Before the RMB achieving fully convertible, promoting the RMB internationalization through the development of the offshore market is necessary and feasible. Then, after the RMB fully convertible, will the offshore RMB market shrink or even disappear gradually with the rise of onshore market? How about the relationship between the offshore and onshore market? First, we observe the evolution process of the domestic offshore market of US dollar, Japanese yen and other currencies after the opening of onshore market. Then we explore the source of the evolution and analyze the change of the relationship between the two markets. Finally we predict the possible changes of the relationship between them after the RMB fully convertible.

3.1. The role of the domestic offshore market weakened gradually after the onshore market fully open

Offshore market can be located in the domestic; also can be in overseas. Domestic offshore market represented by the United States International Banking Facilities (IBFs) and Japan JOM, also including Thailand Bangkok International Banking Facilities (BIBF).
On December 3, 1981, the United States established IBFs in order to attract native American Banks and overseas financial institutions to engage in international financial business in the United States financial market, improve the competitiveness of the U.S. financial markets and keep vigor of the United States local market. The authority of the United States allowed domestic banks through law to provide non-resident customers with financial services such as savings and loans through setting up separate accounts, using their domestic institutions and equipment and enjoy loose policies similar to that in overseas offshore market, such as that they can not be subjected to reserve required ratio and loan interest rates restriction set by Federal Reserves and can be absent from the federal deposit insurance. Although the dollar had been the international currency when the IBF were established, there was tough regulation on interest rates and capital controls in the U.S. onshore market, which makes the onshore dollar market much far behind the Eurodollar market, especially the London dollar market in the matter of activity level and competitiveness. Therefore, the historical background of the establishment of the IBF has certain similarity and comparability with that of the internationalization process given a national currency, as they both have regulation on the onshore market and prosperity of the offshore market. At the beginning foundation of IBF, IBF worked as intended. The size of assets for the proportion of total overseas assets rose from 25% in 1981 to around 55% in 1987. But as the dollar onshore control gradually disappears, IBF lost its base of rapid development. It was getting weaker in the competition with other dollar offshore markets. Its proportion of assets sizeto total overseas assets underwent a continued decline, fell to less than 25% in 2000 and never reached this level again\(^{19}\).

Look at the domestic offshore market launched in the process of national currency internationalization – Japan’s JOM and Thailand’s BIBF. In December 1986, in order to take Tokyo as an international financial center, speed up the

\(^{19}\) Data from the BIS,http://www.bis.org/
Yen internationalization, reduce the operating costs of commercial Banks and get rid of the Yen’s attachment to the dollar, Japan founded JOM. JOM was artificially isolated from the onshore market, interest tax-free, no interest rate control, reserve requirements and could only be engaged in offshore business. But along with the opening up of the onshore Yen, the proportion of Yen in JOM was already shrinking. Since 1996 the proportion of Yen assets in JOM all assets decreased gradually from around two-thirds to around a third. The proportion of Yen liabilities in JOM all liabilities has been under 20%. Moreover, it was even less than 5% in many years\(^{20}\). In March 1993, in order to speed up the Thai baht internationalization, BIBF was founded. But it has been largely covered in the dust of history.

As you can see, as the onshore market fully open and the disappearance of the barrier between onshore and domestic offshore market, the size of the domestic offshore market has started to shrink and its effect will gradually diminish.

### 3.2. The source of the different evolution path for the two types of offshore market

Along with the onshore market fully opened, the domestic offshore markets have shrunk or even disappeared. Although the overseas offshore market is no longer considered as the offshore market, on the whole, the business given a currency did not shrink and even increased instead. The different evolution paths between the two types of offshore market in and after the opening process of the onshore market are inseparable from their geographical location and policy environment. Their formation is also passed two different ways. The formation of the domestic offshore market is depending on the policy promoting of the currency sovereign state. Whether the IBF of the U.S., the JOM of Japan, or the BIBF of Thailand, completely is a particular market isolated artificially from onshore by the power of the policy, while the onshore market had not fully

\(^{20}\) Data from the BoJ.http://www.boj.or.jp/en/index.htm/
opened or under restriction. Most of the overseas offshore markets, represented by the Eurodollar market, including the euro market in London and yen market in Singapore, are based on the real demand of offshore currency to participate in lots of offshore business. Although the development of these centers are restricted by the open degree of the onshore market and affected by the monetary policy of the authority, they are located out of the jurisdiction of currency sovereign and market demand is the dominant fact in their formation and development.

With the opening up of the onshore market, the driver of policy in the domestic offshore market gradually disappears. Policy factors between the two markets gradually tend to be the same and the barrier is also going to fade out gradually. The participants in domestic offshore market shift to onshore business and become a part of the onshore market quickly after the fully opening of the onshore market due to the lack of support of offshore economic and the geographical advantages to enter the onshore market. The overseas offshore markets and the onshore market are promoted and penetrated by each other gradually during the process of the onshore market opening. The scale of the overseas offshore markets may vary. The overseas financial business of this currency in these markets will not shrink, but increase instead, such as that in the European dollar market, due to the factors such as geographical advantages and financial aggregation effect etc. At the same time, the offshore market (or more specifically, the financial business of that currency conducted in the overseas financial centers) together with the financial business did in the onshore market will form a global currency market which is larger, more complete and orderly competitive (e.g. global US dollar market). The financial business of that currency conducted in all these centers complements each other to form a global covered and uninterrupted market in different geography position. Therefore, after the onshore market fully open, the basic reasons of the different evolution path between the two types of offshore market are whether
there is enough real demand of offshore currency and whether it is completely dependent on policy support to exist and develop.

3.3. The possible relationship between offshore and onshore market after the RMB fully convertible

London, Singapore RMB offshore markets have the same market properties with the Eurodollar market, Singapore Japanese yen market and other overseas offshore markets. Therefore, they would probably have similar evolution path. Hong Kong is a part of China, but it is not within the monetary jurisdiction of the central bank. Although Hong Kong has got some policy supports in the process of the development of the offshore RMB market, it also has a huge demand of real offshore RMB. So Hong Kong is fundamentally not the same as the traditional domestic offshore market. After the onshore RMB market fully opened, the evolution path of Hong Kong's RMB offshore market will not have substantial distinction with London, Singapore and other RMB overseas offshore markets. So we expect that the RMB offshore market, including Hong Kong offshore market, will have an opportunity of development within the process of China onshore market opening. Also we expect it will merge into a unified whole gradually and form a complete global currency market together with fully opened onshore market. In fact, along with the gradually opening and perfecting of the onshore market financial system, especially the more flexibility in the formation mechanism of exchange rate, the gap of exchange rate between onshore and offshore markets has been narrowed and the relationship between the two markets is much closer.

Therefore, establishing and developing the offshore market is a "double-edged sword". On one hand, it can co-develop with the onshore market and contribute to the RMB internationalization. On the other hand, it may have potential adverse effects on onshore market. The key to getting advantages and avoiding disadvantages in the development of the offshore market lies in speeding up the reformation of the onshore market financial system, especially
the price formation mechanism of the interest rate, exchange rate, promoting capital account liberalization moderately and keeping the co-development of the two markets. Or rather, these measures also are helpful for the RMB internationalization and the development of the two markets in the long run.