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Trends in Southeast Asia

CHINA'S ECONOMIC ENGAGEMENT WITH SOUTHEAST ASIA: SINGAPORE

JOHN LEE

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INSTITUTE OF SOUTHEAST ASIAN STUDIES

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FOREWORD

The economic, political, strategic and cultural dynamism in Southeast Asia has gained added relevance in recent years with the spectacular rise of giant economies in East and South Asia. This has drawn greater attention to the region and to the enhanced role it now plays in international relations and global economics.

The sustained effort made by Southeast Asian nations since 1967 towards a peaceful and gradual integration of their economies has had indubitable success, and perhaps as a consequence of this, most of these countries are undergoing deep political and social changes domestically and are constructing innovative solutions to meet new international challenges. Big Power tensions continue to be played out in the neighbourhood despite the tradition of neutrality exercised by the Association of Southeast Asian Nations (ASEAN).

The **Trends in Southeast Asia** series acts as a platform for serious analyses by selected authors who are experts in their fields. It is aimed at encouraging policy makers and scholars to contemplate the diversity and dynamism of this exciting region.

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China's Economic Engagement with Southeast Asia: Singapore

By John Lee

EXECUTIVE SUMMARY

- China is a relatively minor source of Foreign Direct Investment (FDI) into Singapore and pales in comparison to FDI from advanced economies in North America and the European Union. This will remain the case for the foreseeable future despite recent agreements facilitating Chinese firms and capital entering into Singapore, and which reduce the transaction costs of doing so.
- In the critical Singaporean 'Financial & Insurance Services' sector, firms from China are also a relatively small investor.
- When it comes to the foreign portfolio investment (FPI) which helps provide liquidity and capital for Singaporean listed firms, China is a miniscule player.
- Assets of Chinese banks make up a very small percentage of the assets of the very open banking sector in Singapore. Additionally, 'stress tests' confirm that uniform financial distress in ten other countries – all advanced economies with the exception of India – will have a more profound effect on the financial system in Singapore than if such distress occurred in the Chinese banking system.
- The bottom line is that Singapore's standing and status as one of the world's leading and most attractive financial centres prevents Singapore from being over-reliant on any one financial partner; and Singapore is certainly not over-reliant on China.

** This is the fourth in a series on "China's Economic Engagement with Southeast Asia", all written by John Lee. The Southeast Asian countries discussed so far are Thailand, Indonesia and Malaysia.*

China’s Economic Engagement with Southeast Asia: Singapore

By John Lee[1]

INTRODUCTION

With a population of only 5.4 million people, a land area of just over 700 square kilometres, and without an abundance of any natural resource, Singapore’s economic success has been built on a number of policy factors including developing and attracting a highly capable workforce, enhancing the ease of doing business in the city-state, and offering superior commercial infrastructure and institutions compared to its neighbours. In short, Singapore has made a virtue out of the necessity of *openness* to foreign individuals, corporations and capital.

Opening its territorial and economic borders to the outside world has created enormous opportunities and prosperity for the country. This has however, in perception at least, enhanced vulnerabilities. After World War Two, Singapore’s major economic partners were nation-states within the American-led Western alliance system: the United States, United Kingdom, Japan, South Korea etc. China has emerged as the first great strategic and economic power outside that alliance system in the post-World War Two period. Unlike its ties to the former Soviet Union, Singapore has extensive economic relations with China.

This issue of *Trends in Southeast Asia* looks specifically at Chinese ‘capital’ and ‘financial penetration’ into Singapore – both from the point of view of Chinese capital entering Singapore and the role of Chinese

[1] Dr John Lee is a visiting fellow at ISEAS. He is also an Adjunct Professor at the Centre for International Security Studies, University of Sydney; non-resident senior fellow at the Hudson Institute in Washington DC; and Director of the Kokoda Foundation strategic and defence think-tank in Canberra.

firms and assets in Singapore's financial sector. The latter is an important question given the significant role that financial services play in the country's economy.

What seems evident is that there is relatively low penetration of Chinese capital and firms in the Singaporean economy generally, and in the Singaporean financial sector specifically. This is the result of several factors, including the existence of a heavily regulated and restricted Chinese capital account preventing a free outflow of capital. Since Singapore is a highly advanced economy in the region and the world, firms from advanced economies in sectors such as finance and manufacturing will also do better there, and many Chinese firms have some way to go before they can compete in the Singapore's competitive economy.

This *Trends* issue also looks at a number of developments, such as the internationalisation of the Chinese Renminbi (RMB), to see whether these might lead to greater Chinese financial penetration in Singapore. It concludes that such Chinese financial penetration will remain modest for a number of reasons related to the nature of China's political economy, even if China, as is expected, gradually acquires a greater financial role in the international system.

The Importance of the Financial Sector to Singapore

In September 2013, the London-based Z/Yen Group released its 2014 Global Financial Centres Index (GFCI), the authoritative ranking of the competitiveness of financial centres in the world based on surveys of tens of thousands of financial firms and other stakeholders. The result reaffirmed Singapore as one of the top four most competitive financial centres in the world, behind London, New York and Hong Kong, but ahead of illustrious cities such as Zurich, Tokyo and Geneva. The first four cities have in fact held the top four positions since the GFCI was first constructed in 2001.[2] Significantly, when respondents were asked

[2] *The Global Financial Centres Index 14* (London & Qatar: Z/Yen Group, September 2013): http://www.qfc.com.qa/Files/Reports/Global%20Financial%20Centre%20Index%2014.pdf accessed June 20, 2014.

which cities were likely to become more significant in the foreseeable future, Singapore received the most mention. Incidentally, Shanghai, which is currently ranked a relatively low sixteenth, received the second most mention.

Being named a major financial centre or hub is not only about global status or prestige. On the face of it, a global financial centre is simply a location where a substantial amount of financial business is conducted. Yet, being one of the top four or five major financial centres in the world means that the most lucrative and important financial deals are done in that city, offering enormous financial rewards to bankers and other financial services firms located there. Highly paid professionals in finance and related businesses become a significant driver of the local economy – from housing and clothing, to consumption and other services. Financial centre hubs also attract high-status and ancillary businesses such as lawyers, accountants, actuaries, insurers and other valuable professional services.

There are also other macro-economic and systemic benefits. For example, Singapore's status as a global financial hub broadens the investment opportunities for institutions that look after Singaporean savings and other assets. It also encourages local and foreign advanced manufacturing firms and creative industries to locate operations in Singapore, encouraging the growth of highly virtuous 'clusters' of firms in advanced sectors in the country.[3] The fact that a high volume of financial transactions occur in Singapore also means that the local currency will be in high international demand, and be perceived as a 'safe' and 'highly tradable' currency, hence making it easier and cheaper for government and corporate bond issuers and the like.

Being a major financial hub also generates considerable 'soft power' for that city or country. Global financial hubs require good governance and a good track record of low sovereign and political risk, strong

[3] See Jessie P.H. Poon, "Hierarchical tendencies of capital markets among international finance centres," *Growth and Change* 34:2 2003, pp. 135-36; Paola Dubini and Howard Aldrich, "Personal and Extended Networks are Centre to the Entrepreneurial Process," *Journal of Business Venturing* 6:5 1991, pp. 305-13.

institutions such as rule-of-law and property rights, and business-friendly policy settings such as attractive corporate and personal taxation regimes. Financial hubs are also located in attractive cities within attractive political-economic systems. Singapore's status as a top four financial centre therefore enhances and reinforces the country's 'soft power' and relevance in the world – critical for a city-state that has to remain an agile political, diplomatic, strategic, economic and logistical (in terms of commercial shipping) player in a region of giants.

The importance of the financial sector to Singapore's overall economy is clear from figures generated for the Financial Secrecy Index for 2012-13.[4] The financial sector-to-GDP ratio for Singapore is 13.5 per cent, with 5.09 per cent of its 'economically active' population employed directly by the financial services sector. As Table 1 shows, this is high in comparison with its advanced regional economic partners.

The importance of the financial sector is also evident when one looks at surveys released by Hudson, the global human resources consulting

Table 1: Comparative Importance of Financial Sector in Advanced Asia-Pacific Economies

	Financial Sector-to-GDP Ratio (%)	**Working Population in Financial Sector (%)**
Singapore	13.5	5.09
Japan	Unknown	2.88
South Korea	7.5	3.5
Australia	7.7	3.6
New Zealand	< 1	3

Source: Financial Secrecy Index.

[4] http://www.financialsecrecyindex.com/database/menu.xml accessed June 20, 2014.

firm, for the Singapore market.[5] In the first quarter for 2014, 50 per cent of respondents in the banking and financial services sector expected to increase permanent hiring, 41.2 per cent sought to maintain the current volume of workers, and only 8.8 per cent looked to a decrease in permanent positions. As Table 2 shows, the banking and financial sector, already the highest paid sector, is the most bullish in forecasting the offer of permanent positions, which further emphasises the importance of the sector to the overall economy.

Sources and Nature of Foreign Capital in Singapore

Singapore's ambitions to remain a major financial hub in the region and the world are reflected in the nature and activity of foreign capital entering the country. Thus, it has developed one of the most open, low-taxing and business-friendly investment regimes in the world. Let's first look at volumes and makeup of foreign capital in Singapore.

Table 2: Singapore Hiring Expectations, 1st Quarter 2014

	Increase	**Steady**	**Decrease**
Banking & Financial Services	50	41.2	8.8
Consumer	43.2	48.6	8.2
Information Technology & Communications	42.3	52.1	5.6
Manufacturing & Industrial	34.8	59.3	5.9
Healthcare & life Sciences	33.3	60	6.7
All Industries	39.5	53.2	7.3

Source: The Hudson Report.

[5] *The Hudson Report, Quarter 1, 2014*: http://hudson.sg/KnowledgeCentre/HudsonReportQ12014 accessed June 20, 2014.

It is clear from Table 3 that 'Foreign Direct Investment' (FDI) and 'Foreign Equity Investment' (FEI) are the two most important categories of foreign investment entering the country, while more 'exotic' products such as 'Financial Derivatives' are far less important and erratic in volume. Note that FDI includes direct equity investment (DEI) and net lending from foreign direct investors. FEI includes DEI and Foreign Portfolio Investment (FPI). This section will first examine the makeup of FDI and FPI entering the country, and then look at the Singaporean banking sector in greater detail.

(a) FDI into Singapore

FDI comprises both direct equity investment (DEI) and net lending from foreign direct investors. DEI is the far larger component of FDI. In 2012, direct equity investment comprised 89.4 per cent of FDI, with net lending from foreign direct investors making up the remaining 10.6 per cent. In 2011 and 2010, DEI made up 88 per cent and 87.9 per cent of FDI respectively.[6]

Table 3: Stock of Foreign Capital in Singapore 2007-2012 (S$ billion)

	Foreign Direct Inv. (incl. Net Lending)	**Foreign Equity Inv.**	**Financial Derivatives**
2008	510.59	490.64	166.8
2009	574.7	563.13	83
2010	626.4	607.37	87.59
2011	678.91	663.03	84
2012	746.7	733.42	Not avail.

Source: Singapore's Department of Statistics; author's calculations.

[6] Singapore Department of Statistics figures.

From Table 4, it is evident that having risen sharply from a very low base in the middle of the previous decade, the volume of Chinese FDI into Singapore in relative terms has largely plateaued over the past few years. Indeed, it has been argued that Indian FDI into Singapore is the more exciting and important development. If the Indian economy picks up significantly following the decisive election victory of Prime Minister Narendra Modi in June 2014 as some now anticipate,[7] then we are likely to see a significant rejuvenation of Indian FDI entering Singapore.

Moreover, it is also clear that capital from the advanced economies of the European Union, the United States and Japan remain far more important than that originating in China. In other words, China is not emerging as a dominant source of FDI volume for the Singaporean economy.

This is the case even as agreements are signed which now allow Chinese companies registered in the Mainland to list on the Singapore

Table 4: Stock of FDI by Source Country, 2006-2012 (% of all FDI)

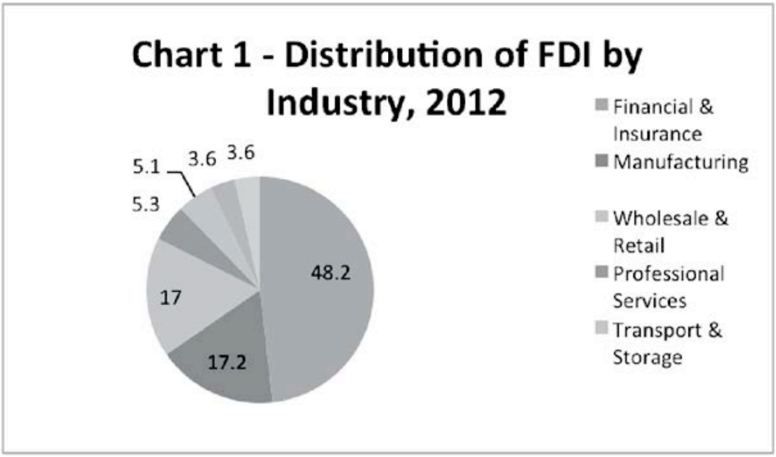
	2006	**2008**	**2010**	**2011**	**2012**
China	0.46	0.87	2.24	2	1.9
Japan	12.14	9.9	8.55	7.91	7.92
India	0.7	3.3	3.91	3.41	2.95
Malaysia	2.27	2.5	2.31	2.93	3.63
Taiwan	2.04	1.3	0.92	1.1	1
Australia	0.9	0.9	1.27	1.36	1.38
Europe	46.98	39.92	36.86	38	34.99
U.S.A.	10.35	10.33	10.72	11.92	14.26

Source: Singapore's Department of Statistics; author's calculations.

[7] For example, see Arvind Panagariya, "How Modi Can Revive India's Economy," *BBC*, June 4, 2014 http://www.bbc.com/news/world-asia-india-27659440 accessed June 22, 2014.

Exchange (SGX),[8] potentially making Chinese DEI and FPI in Singapore easier. There are some suggestions that large Chinese firms that list on the SGX and successfully tap into Singapore equity markets will in turn use this foothold to significantly increase FDI activity in Singapore. But one must bear in mind that Singapore already has a very open FDI (and Direct Equity Investment or DEI) regime, and if there is a demand from Chinese firms to pour significantly more equity capital into Singapore, it would be happening already. In fact, the agreement allowing Chinese firms to list on the SGX is more a useful mechanism for Chinese firms to raise capital from outside China than it is a mechanism to massively increase the amount of Chinese FDI entering Singapore.

The next issue to look at are the sectors targeted by foreign investors channelling FDI into Singapore.



Source: *Singapore's Department of Statistics.*

[8] See Jake Maxwell Watts, "Singapore to Allow Mainland Chinese Listings," *Wall Street Journal*, November 27, 2013 http://blogs.wsj.com/moneybeat/2013/11/27/singapore-to-allow-mainland-chinese-listings/ accessed August 12, 2014.

It is obvious that the Financial & Insurance Services sector dominates, receiving 48.2 per cent of all FDI in 2012. This highlights Singapore's status as a regional and global financial hub. Manufacturing and the Wholesale and Retail Trade sectors are also prominent, receiving 17.2 per cent and 17 per cent respectively of all FDI. The manufacturing sector, which accounts for about one third of the country's GDP, tends to be dominated by firms from advanced economies locating high-value added processes in Singapore; with positive spill-over effects for local firms. Indeed, around three quarters of foreign manufacturing firms in Singapore are from Japan, the U.S. or the E.U. countries.[9] This is similar to other manufacturing hubs in Asia such as Thailand and Malaysia.[10] Wholesale and retail segments are also dominated by advanced economy FDI largely servicing local consumers with international branded products and using Singapore as a distribution hub for the wholesale sub-category. In 2012, for example, there was S$9.98 billion of outstanding Japanese FDI into Singapore's manufacturing sector, S$1.13 billion from Malaysia, S$2.74 billion from Taiwan, S$64.53 billion from the E.U., and S$16.96 billion from the U.S. In comparison, there was only S$303.1 million from China.[11]

The interest in this paper is to look more closely at FDI in the Financial and Insurance sector specifically, not only because this sector dominates receipts of FDI but because of our interest in foreign 'financial

[9] For example, see Singapore, Ministry of Trade and Industry, "Productivity Spillovers To Local Manufacturing Firms From Foreign Direct Investment," *Economic Survey of Singapore First Quarter 2012*, May 17, 2012: http://www.mti.gov.sg/ResearchRoom/SiteAssets/Pages/Economic-Survey-of-Singapore-First-Quarter-2012/FA_1Q12.pdf accessed June 23, 2014.

[10] See John Lee, *China's Economic Engagement with Southeast Asia: Thailand* (Singapore: ISEAS Trends in Southeast Asia # 1, 2013): http://www.iseas.edu.sg/documents/publication/Trends_2013-1.pdf; *China's Economic Engagement with Southeast Asia: Malaysia* (Singapore: ISEAS Trends in Southeast Asia #1, 2014): http://www.iseas.edu.sg/documents/publication/Trends_2014_1.pdf accessed June 23, 2014.

[11] Singapore's Department of Statistics figures.

penetration'. Note that the vast majority of FDI into the Financial and Insurance Services sector goes into investment holding companies. In 2012, S$305.6 billion worth of FDI went into 'Investment Holding' compared to only S$17 billion for 'Banks' and S$10.8 billion for 'Insurance Services'. In 2011, the figures were S$249 billion, S$14.5 billion and S$7.8 billion respectively in these sub-sectors.[12]

Although China's share of FDI in Singapore's 'Financial and Insurance' sector has increased from 1.22 per cent of all FDI in this sector in 2008 to 2.58 per cent in 2012, these numbers begin from a very low base. Moreover, Chinese FDI into this sector appears to have plateaued for the moment. Indeed, the big mover has been the U.S. who has increased its share from 11.28 per cent in 2008 to 18.95 per cent in 2012. The fact that U.S. FDI in this sector began from a very high base in 2008 only serves to underline the reality that the advanced economies continue to dominate FDI into the all-important 'Financial and Insurance' sector for Singapore in terms of absolute size and volume, and trend growth. When one considers FDI from only Asian countries

Table 5: Stock of FDI in Singapore's Financial & Insurance Sector by Country, 2008-2012, S$ billions

	2008	2009	2010	2011	2012
China	2.57	Not. Avail	9.34	9.79	9.26
India	14.35	18.04	19.57	19.53	19.52
Japan	12.37	12.78	15.06	17.24	17.98
Malaysia	8.25	10.5	8.88	13.74	18.16
Australia	3.16	4.23	5.37	5.76	7.04
U.S.	23.71	30.23	34.6	38.32	68.13
E.U.	66.32	68.86	74.37	77.92	82.73

Source: Singapore's Department of Statistics.

[12] Singapore's Department of Statistics figures.

into Singapore, China's share has doubled from 4.7 per cent in 2008 to 9.43 per cent in 2012. This is a dramatic increase but is still low in terms of volume.

(b) FPI in Singapore

In these statistics, foreign entities investing ten per cent or more in a commercial entity in Singapore is counted as FDI. This means that FDI entities generally acquire a long-term interest in that commercial entity and also possible management rights based on how much equity capital the foreign entity has invested.

FEI includes both Direct Equity Investment (DEI) and Foreign Portfolio Investment (FPI). DEI refers to equity capital in Singapore that comes from foreign direct investors and is the dominant component of FDI (constituting about 90 per cent of FDI.)[13] In contrast, FPI refers to passive holdings of securities such as foreign stocks, bonds, or other financial assets that do not entail active management or control of the securities by that foreign investor. In other words, FPI is far more fluid since foreign investors can much more easily sell their stake in that Singaporean entity, unlike FDI where divestment involves the more cumbersome task of selling plant, property equipment or goodwill in an investment, or else writing off the investment.

In 2012, FPI constituted only 9 per cent of FEI, or S$66.05 billion out of S$733.41 billion worth of FEI. Even so, FPI is important because it provides liquidity and capital for Singaporean listed and private companies (the latter through foreign contributions to private equity funds etc.,) and alleviates the problem faced by smaller countries where domestic household savings and domestic corporate funds available for investment are limited.

As one might suspect, the 'Financial and Insurance' sector dominates FPI. In 2011 and 2012, this sector received 86.8 per cent and 87.2 per

[13] Singapore Department of Statistics figures: http://www.singstat.gov.sg/statistics/browse_by_theme/economy/findings/fei_infographic_findings.pdf accessed August 12, 2014.

cent of all FPI respectively.[14] Although we do not have figures for FPI in the 'Financial and Insurance' sector broken down by source country, we do have figures for FPI by source country across all sectors. Given that the 'Financial and Insurance' sector is such a dominant recipient of FPI, across-the-board FPI figures by country of origin will fairly closely reflect FPI figures by country in the 'Financial and Insurance' sector.

Table 6 shows no doubt that China is a surprisingly small player when it comes to FPI, representing 0.38 per cent of all FPI from Asia and a miniscule 0.05 per cent of all global FPI into Singapore.

Singapore's financial system is dominated by banks, as Chart 2 shows.

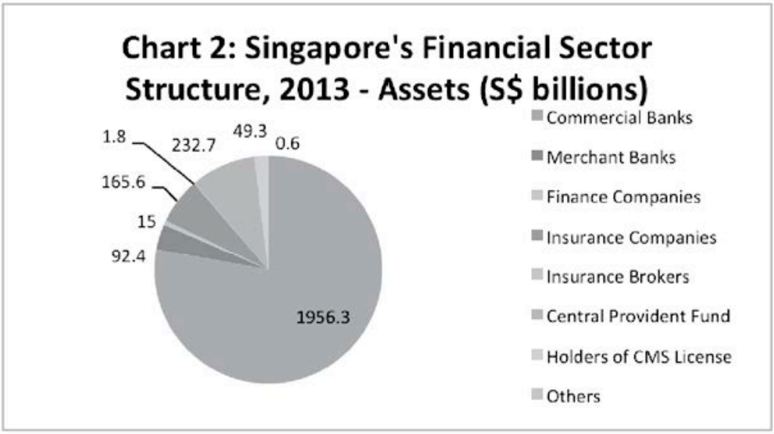
Commercial banking is clearly the largest and most important category in the financial system. In terms of the commercial banking sector, the assets/liabilities of the three large local banks – DBS, United Overseas Bank and Overseas-Chinese Banking Corp – amount to 102 per cent, 73 per cent and 86 per cent respectively of Singapore's GDP

Table 6: Stock of FPI in Singapore By Source Country, 2008-2012, S$ millions

	2008	**2009**	**2010**	**2011**	**2012**
China	18.4	766.7	108.7	16.2	31
India	40	49.7	22.7	44	74.8
Japan	328.5	377.6	548.5	845.2	814.8
Malaysia	1,855.3	1,586.1	1,833.7	2,063.7	2,211
Australia	481.8	423.9	679.4	600.9	593.5
U.S.	19,582.1	22,435.7	22,272.4	23,808.5	23,387.9
E.U.	8,405.6	10,263	12,578.2	15,708.3	15,631.5

Source: Singapore's Department of Statistics.

[14] Singapore's Department of Statistics figures.



Source: *Monetary Authority of Singapore*.[15]

in 2013.[16] Predominantly due to the local 'Big Three', the assets of local banks represent around 30 per cent of all assets in the banking system, meaning that they have a strong presence in the Singaporean banking sector.

Even so, and given the dominance of the 'Financial and Insurance' sector in attracting foreign capital, it is not surprising that foreign banks represent about 65 per cent of total bank assets. In 2012, S$1,340.8 billion of bank assets were held by foreign banks, compared to the S$615.5

[15] Full banks can conduct the whole range of banking business, including retail deposit taking. Qualifying Full Banks (QFBs) have privileges regarding the number of places of business (up to 25). In June 2012, QFBs with a large retail presence will be required to locally incorporate their retail operation. In addition, QFBs that satisfy certain qualifying criteria and are assessed to be 'significantly rooted' will be allowed to establish up to 50 places of business. The remainder that do not meet all QFB criteria and are therefore not QFBs are known as 'Other Full Banks'. Wholesale branches are allowed to take wholesale domestic funding but not retail. Purely offshore branches are generally not allowed to accept Singapore dollar deposits from residents.

[16] Monetary Authority of Singapore figures.

billion held by local banks. According to June 2013 figures, there were 122 commercial banks operating in Singapore. Five were local banks, one was a foreign subsidiary, and 116 were foreign branches.[17] China has two banks with branches in Singapore, the first being the Bank of China and the second being the Industrial and Commercial Bank of China. Both have 'Qualifying Full Bank' status which means that they can open up to 25 branches, with the possibility of 50 branches if they incorporate their retail operations locally in Singapore.

As Chart 3 shows, one should not overstate the weight of Chinese banks operating in the Singapore market. The assets of Chinese banks make up a very small percentage of overall banking assets in Singapore. Of the top twenty-seven banks operating in the country, the Bank of China is ranked twenty-sixth, just ahead of the Royal Bank of Scotland, and the Industrial and Commercial Bank of China does not even make the list. The Bank of China has around S$15 billion in assets while DBS has about S$350 billion, OCBC almost S$300 billion and UOB over S$260

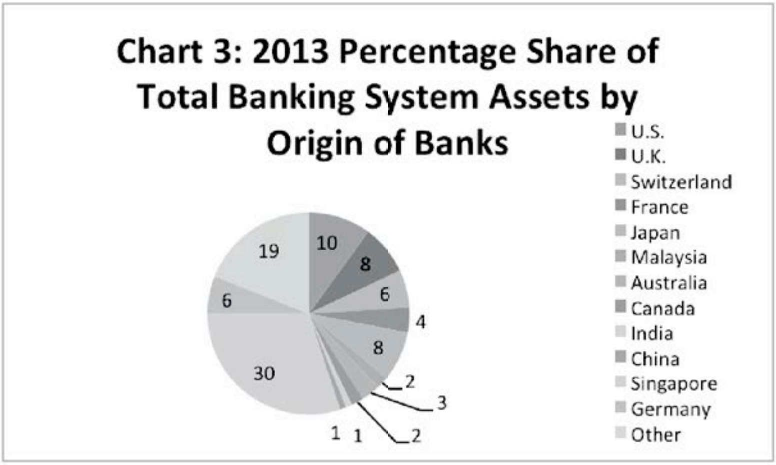


Chart 3: 2013 Percentage Share of Total Banking System Assets by Origin of Banks

Source: *Monetary Authority of Singapore; International Monetary Fund.*

[17] Monetary Authority of Singapore figures.

billion. Standard Chartered, Citibank, Deutsche Bank, UBS, HSBC, Bank of Tokyo and Credit Suisse all have over S$50 billion in assets.[18]

Indeed, 'stress tests' of the financial system in Singapore in the form of credit and funding shocks conducted by the IMF reveal that uniform distress in the banking systems of Germany, the U.K., the U.S., Japan, France, South Korea, Hong Kong, Switzerland, India and the Netherlands (in descending order) will have a greater deleterious effect on the financial system in Singapore than if there were distress in the Chinese banking system.[19] Distress in the German, British and American banking systems would be five times worse for Singapore compared to similar distress in the Chinese banking system. Distress in the Japanese banking system would be four times worse, and distress in the French banking system would be two-and-the-half times worse for Singapore compared to similar distress in the Chinese banking system. This is all further evidence that Chinese 'penetration' in the Singaporean banking and financial system is relatively small.

(c) Analysis: Why China Punches Beneath Its Economic Weight

Given the absolute size of the Chinese economy – the second largest in the world and largest in Asia – and high volume of trade China conducts with countries in the region including Singapore, it is reasonable to ask why China's financial weight in a gateway city-state like Singapore sits alongside smaller countries such as the Netherlands, Malaysia, Australia, and Indonesia. To put the question another way, why does the Chinese financial and investment role in Singapore lack the weight and importance, when compared to countries such as the U.S., U.K., Germany Japan, France and even India? There are a number of reasons why this is the case.

[18] Monetary Authority of Singapore figures.

[19] International Monetary Fund, "Singapore: Financial System Stability Assessment," *IMF Country Report No. 13/325*, November 2013: https://www.imf.org/external/pubs/ft/scr/2013/cr13325.pdf accessed June 23, 2014.

First, China continues to have a heavily regulated and relatively closed capital account. In terms of moving capital out of the country, a limit of US$50,000 a year is imposed on individuals while most corporate investments abroad need government approval. This means that rather than flooding regional markets with surplus capital, the enormous pool of Chinese domestic household and corporate savings is deliberately kept within the Chinese economy financial system.

Although China's capital controls system is somewhat porous – with an estimated US$1,076 billion of illicit outflows mainly through current account or trade over-invoicing[20] – capital controls are retained by Beijing precisely because there is a high domestic demand for mass capital flight out of the country. Illicit capital flight can hardly be used for political leverage by Beijing in the financial or economic system of another country because the purpose of illicit capital flight out of China is to avoid its detection by the Chinese government.

More generally, the Chinese political economy is structured in such a way that opening the capital account would be dangerous for the heavily leveraged Chinese economy. The Chinese financial system is still dominated by the formal banking sector, which constitutes around 80 per cent of the financial system in terms of formal assets and liabilities of financial institutions. The 'Big-Four' state-owned banks alone constitute around 55-60 per cent of the banking system, one in which all state-owned and collective banks constitute around 95 per cent; with foreign banks making up less than 2 per cent.[21] Deposits from household and corporate savings constitute the predominant source of capital in the Chinese financial system. The bond market, making up around ten per cent of loans, is relatively undeveloped in the Chinese system.

[20] See Dev Kar and Brian LeBlanc, *Illicit Financial Flows from Developing Countries: 2002-2011* (Washington DC: Global Financial Integrity, December 2013): http://gfintegrity.org/wp-content/uploads/2014/05/Illicit_Financial_Flows_from_Developing_Countries_2002-2011-HighRes.pdf accessed June 24, 2014.

[21] People's Bank of China figures. See also Dinny McMahon, "In China, Foreign Banks Still Lag Behind," *Wall Street Journal*, September 19, 2011: http://online.wsj.com/news/articles/SB10001424053111904491704576574281790473152 accessed June 24, 2014.

From 2009 to 2013, and using People's Bank of China figures, net new deposits in Chinese banks hovered around US$2.4-2.88 trillion. Yet, outstanding loans increased from US$6.4 trillion in 2009, to US$ 7.36 in 2010, to US$8.8 trillion in 2011, to US$10.08 trillion in 2012, to about US$ 11.2 trillion in 2013. At the same time, lending through the so-called unregulated shadow banking system which includes lending through unmonitored trust funds, micro-finance companies, credit-guarantee companies and even pawnshops has exceeded the amount of new net deposits in the banking system each year since 2009. For example, in 2013, there was an estimated US$11.2 trillion in formal loans, an estimated US$2.88 trillion in unregulated shadow-banking loans and only about US$2.56 trillion in net new deposits.

Note that shadow-banking loans tend to source capital initially from the formal banking system which are lent out at artificially low rates to mainly state-owned-enterprises (SOEs), and then on-lent to other recipients at higher interest rates (the latter being unregulated and constituting the 'shadow-banking' component of lending.) This means that defaults in the shadow-banking system will eventually be reflected in the loan books of the formal banks whose balance sheets are ultimately guaranteed by the government.

According to JP Morgan, there is around US$12 trillion in outstanding formal loans currently, and around US$7.5 trillion in outstanding unregulated loans. This means that outstanding debt which Chinese state-owned banks are ultimately responsible for amounts to about 226 per cent of Chinse GDP (with most credible independent organisations estimating debt to be somewhere between 200-250 per cent of GDP.) To put this in context, the increase in debt within the Chinese financial system over the past five years alone of US$10-15 trillion exceeds the entire amount of outstanding credit in the U.S. commercial banking system.

It is estimated that local government debt (largely through the creation of investment financing vehicles by local authorities to take advantage of the cheap or free credit available) is around US$3 trillion with much of it entering the residential property market. This is worrying because local governments, unable to collect taxes directly, have grown reliant on investment gains by financing vehicles to supplement their budgets. These financial vehicles have subsequently used highly inflated residential property as further collateral for investment – much of it being poured back into the residential property sector. If there is a significant fall in residential property prices, as many analysts expect, then defaults by local government financial vehicles will lead to a massive spike in bad loans throughout the financial system, which currently at a few percentage points of outstanding loans according to official figures is already grossly understated. If and when bad debt hit the formal banking sector, these will effectively become government liabilities. Given that China does not yet have deep and effective capital and bond markets, helping its bank SOEs stabilise their finances will be no easy matter for the central government.

The relevance of these points for the paper is that Beijing needs to ensure Chinese household and corporate savings are kept circulating within the domestic financial system since such savings may be needed to stabilise the financial system. Even if systemic risks to the Chinese financial system are overplayed, Beijing nevertheless is committed to 'deleveraging' the economy. As it does so by slowing credit growth, growth in asset prices in the property and other markets will slow, and possibly even decline in absolute terms. If and when that occurs, defaults by local government entities, private corporations and even some SOEs will certainly occur, meaning that Beijing will need domestic savings to remain in state-owned banks to ensure prudential reserve ratio requirements are met, and even to prevent destabilisation of the banking system. Relaxing the capital account and allowing significant capital flight out of the country will jeopardise Beijing's capacity to undertake a relatively pain-free deleveraging process, or manage the non-performing loans that are undoubtedly hidden in opaque financial accounts.[22]

[22] See "China's Banks Bad-Debt Ratio Seen Rising to Most Since 2009," *Bloomberg*, May 28, 2014: http://www.bloomberg.com/news/2014-05-28/china-banks-bad-debt-ratio-seen-rising-to-most-since-2009.html; John Lee, "China grasps for a growth alternative," *Business Spectator*, September 3, 2012: http://www.businessspectator.com.au/article/2012/9/3/interest-rates/china-grasps-growth-alternative both accessed June 24, 2014.

Deleveraging the Chinese economy, and reforming and transforming the Chinese financial and banking system will take many years, if not a couple of decades. This means that with the pool of domestic savings legally confined to the Chinese financial system through a heavily regulated capital account, China will continue to be less of a presence in regional and global financial centres than one would expect. While there is speculation that liberalising the capital account will actually cause a net inflow of funds into the country on the speculative hope that the artificially suppressed value of the RMB will rise dramatically (which also assumes RMB liberalisation,) Beijing is highly unlikely to take that risk. Even if that occurs, such speculative inflows will be transient, and will exit the country once the RMB rises rapidly as expected.

Besides, the evidence of structural risk of capital flight from within China's pool of domestic savings is undeniable. The main evidence is the huge volume of illicit capital flight that has already occurred. In terms of future intention, a *Huron Report* survey of 980 Chinese citizens worth over US$16 million is typical. According to that survey, 64 per cent are looking to leave China for a Western country, with the U.S. listed as the most preferred destination.[23] According to some experts, mass capital flight presents a genuine systemic risk to the Chinese financial system and economy.[24]

[23] See Robert Frank, "Rich Chinese Continue to Flee China," *CNBC*, January 17, 2014: http://www.cnbc.com/id/101345275; John Lee, "Capital flight is China's house of cards," *Business Spectator*, February 12, 2014: http://www.businessspectator.com.au/article/2014/2/12/china/capital-flight-chinas-house-cards both accessed June 24, 2014.

[24] For example, see Dexter Roberts, "Is Capital Fleeing China?", *Bloomberg Businessweek*, February 17, 2012: http://www.businessweek.com/articles/2012-02-17/is-capital-fleeing-china; "Confidence Game," *China Economic Review*, September 27, 2012: http://www.chinaeconomicreview.com/confidence-game'; Shae Smith, "Chinese Banks: Will Missing Yuan Trigger a Capital Flight of China's Black Swan?", *Money Morning*, March 3, 2012: http://www.moneymorning.com.au/20120303/chinese-banks-will-missing-yuan-trigger-a-capital-flight-of-chinas-black-swan.html all accessed June 24, 2014.

Bear in mind also that despite talk about reforming the Chinese growth model towards one driven primarily by domestic consumption, the Chinese economy remains predominantly driven by domestically funded fixed investment by SOEs.[25] Bank lending is the primary source of financing for such activity. Indeed, Chinese consumers are 'financially repressed' through receiving artificially low deposit rates which are capped, and whose savings are then used to fund the fixed-investment activities of SOEs who receive loans at very cheap levels. In other words, Chinese consumers and savers are effectively subsidising the investment activity of SOEs. Rapidly reforming such an economic model would impose immediate economic costs and shocks to the Chinese economy, explaining why there have been few genuine reforms that reverse the repression of households and consumers in favour of SOEs and fixed investment activity. The upshot, once again, is that Beijing needs to prevent domestic capital flight in order to finance this economic model.[26]

Second, one might expect that China's huge cache of foreign exchange reserves that are estimated at around US$3.95 trillion should make more

[25] For example, see *China 2030: Building a Modern, Harmonious, and Creative Society* (Washington DC: World Bank, 2013): http://www.worldbank.org/content/dam/Worldbank/document/China-2030-complete.pdf; Michael Pettis, "Will the reforms speed growth in China?", *Michael Pettis' China Financial Markets*, January 5. 2014: http://blog.mpettis.com/2014/01/will-the-reforms-speed-growth-in-china/ all accessed June 26, 2014.

[26] See John Lee, "China can't beat economic laws," *The Australian*, August 20, 2013: http://www.theaustralian.com.au/national-affairs/opinion/china-cant-beat-economic-laws/story-e6frgd0x-1226700145041; "China's Corporate Leninism," *The American Interest* April 2012: http://www.the-american-interest.com/articles/2012/04/10/chinas-corporate-leninism/; Michael Pettis, "Monetary policy under financial repression," *Michael Pettis' China Financial Markets*, December 20, 2013: http://blog.mpettis.com/2013/12/monetary-policy-under-financial-repression/; "China has a choice: short-term growth or sustainability," *Financial Times*, September 2, 2013: http://www.ft.com/intl/cms/s/0/18446f64-11a7-11e3-8321-00144feabdc0.html#axzz35WGpTnS9 all accessed June 24, 2014. See also Chin Lo, *The Renminbi Rises: Myths, Hypes and Realities of RMB Liberalisation* (Basingstoke: Palgrave McMillan 2013) on obstacles facing Chinese liberalisation of its capital account.

of a splash in the Singaporean economy – either through parking cash in Singapore's financial system or buying Singapore-based assets. But it is poorly appreciated that there are effective liabilities against a large proportion of its forex reserves, meaning that Beijing needs to place the reserves in safer passive investments rather than in higher return but riskier ventures.

To explain, about sixty per cent of China's forex reserve – approximately US$2.4 trillion – emanates from the current or trading account and effectively represents the trade surpluses with countries such as the U.S. and countries in the E.U zone. To illustrate, assume that a Chinese-based manufacturer sells a plasma television to an American consumer for US$100. The American consumer pays the money to the importer who subsequently transfers the agreed amount to the Chinese manufacturing firm – let's make it US$50. The People's Bank of China (PBoC) takes possession of the US$50, and issues an RMB equivalent 'IOU' to the bank of the Chinese manufacturer, upon which the RMB equivalent appears in the local bank account of the Chinese manufacturer. This means that the PBoC has to hold on to the foreign currency and 'park' its money outside China in a foreign currency-denominated asset. China generally buys U.S. government-backed bonds because America is the only economy in the world with sufficient deep and safe capital markets to reliably absorb that amount of hard currency.

This means that the PBoC cannot tolerate a high degree of risk in its holdings of foreign currency because they are collateral for the IOUs issued to domestic banks held on behalf of Chinese exporters; the PBoC needs the money to be there. Hence, the PBoC is forced to buy trillions of dollars of low-yielding U.S. Treasury and other government-backed bonds. Note also that in order to maintain its effective RMB peg to the greenback, the PBoC cannot sell a substantial amount of its bond holdings in U.S. dollars and use the proceeds from the sold U.S. bonds to buy assets denominated in other currencies as this would lower the value of the US$ vis-à-vis the RMB, playing havoc with the RMB's peg. Indeed, to maintain the peg and artificially suppress the RMB vis-à-vis the greenback, the PBoC is forced to continually buy more U.S. dollar-denominated assets (mainly government bonds) in order to stop the RMB appreciating while it continues to have trade surpluses with the U.S.

(since surpluses in the current account would tend to appreciate the value of the RMB vis-à-vis the greenback if the RMB was freely exchanged.)[27]

Most of the other forty per cent – approximately US$1.6 trillion – of China's forex reserves mainly comes from operations in the current account as foreign capital enters China either in the form of FDI or 'hot money' inflows disguised as FDI used for speculating on RMB appreciation in the near future.[28] Let's assume a foreign firm wants to invest US$100 in China. The US$100 is held by the PBoC and the foreign investor is given the equivalent amount in RMB. The US$100 needs to be available to that investor in case they choose to exit the Chinese market by selling RMB back to the PBoC, in turn receiving back their US$100. In reality, foreign investors would not generally choose to exit China so quickly and the Chinese government can slow the exit of capital out of the country even if it cannot stop it. But the point remains that there are formal liabilities against the US$100 held by the PBoC in this context and the PBoC cannot simply inject forex reserves into ill-considered or risky investments in the region.[29]

Third, one needs to account for why the level of Chinese FDI in Singapore's financial sector in particular is relatively small. It comes down to government priorities. Given that Chinese SOEs are behind around 90 per cent of all outbound FDI by volume, sectors targeted by Chinese companies tend to correspond closely with government policy and related incentives.[30] Recent figures for 2014 FDI emanating

[27] See James Parker, "The Dollar Trap: China's Misunderstood Foreign Exchange Reserves," *The Diplomat*, September 28, 2012: http://thediplomat.com/2012/09/the-dollar-trap-china's-misunderstood-foreign-exchange-reserves/ accessed June 24, 2014.

[28] See Edward Chancellor, "China's cash pile provides no shield," *Financial Times*, August 5, 2012.

[29] See Ling Huawei, "What should China buy with its $3.9 trillion reserves?", *Caixin Online*, June 17 2014: http://www.marketwatch.com/story/what-should-china-buy-with-its-39-trillion-reserves-2014-06-17/print?guid=8553B744-F672-11E3-8433-00212803FAD6 accessed June 24, 2014.

[30] See Derek Scissors, "Chinese Outward Investment: More Opportunity Than Danger," *The Heritage Foundation Backgrounder #2579*, July 13, 2011: http://www.heritage.org/research/reports/2011/07/chinese-outward-investment-more-opportunity-than-danger accessed June 24, 2014.

from China show that Chinese firms have invested US$370 billion in the energy sectors, US$111 billion in transport sectors, US$114.6 billion in metals sectors and US$74.3 billion in real estate. The energy and metals sectors tend to be driven by China's search for resource security,[31] not prominent sectors in the Singaporean economy. Indeed, the leading countries receiving Chinese FDI tend to be energy and metal rich economies such as Australia (US$60.6 billion), Kazakhstan (US$21.8 billion), Iran (US$18.6 billion), Russia (US$18.5 billion), Canada (US$37.8 billion), Brazil (US$32.1 billion), Venezuela (US$16.1 billion), Nigeria (US$20.5 billion), Ethiopia (US$11.7 billion), Angola (US$9.7 billion), Saudi Arabia (US$17.3 billion), Iraq (US$14.5 billion) and Algeria (US$14 billion.) Even in Asia, Chinese FDI tends to focus on resource rich countries such as Indonesia (US$27 billion) and Malaysia.

In comparison, Chinese firms have invested only US$39.1 billion worldwide in financial sectors that are Singapore's strength. With respect to financial sectors, the main destinations for Chinese FDI in Asia are Taiwan (US$680 million), Thailand (US$530 million), Australia (US$330 million) and Japan (US$190 million).[32]

Furthermore, the leading foreign players in Singapore's financial and banking system are firms from advanced and open economies such as the U.S., U.K., Japan, Switzerland and Germany. Banks from these countries are far more market-responsive and customer-focused than Chinese banks, and offer far superior and better-tailored financial products and solutions in sophisticated markets such as Singapore's.

In contrast, Chinese banks exist in monopolistic environments, are heavily protected and offered substantial government help and support, and lack the same incentive to respond to markets or tailor sophisticated or creative products for different customers. For example, China's 'Big Four' state-owned banks earn the majority of their profits from the policy-enforced spread between deposit and lending rates, an easy way

[31] See John Lee, "China's Geostrategic Search for Oil," *Washington Quarterly* 35:3 2012, pp. 75-92: http://csis.org/files/publication/twq12SummerLee.pdf accessed June 24, 2014.

[32] Figures from American Enterprise Institute – Heritage Foundation China Global Investment Tracker: http://www.heritage.org/research/projects/china-global-investment-tracker-interactive-map accessed June 24, 2014.

of generating profit in China's heavily controlled political economy. Chinese banks simply need to lend high volumes to ever credit-hungry SOEs knowing that the majority of loans to these institutions are implicitly guaranteed by the government.

In fact, according to 2012 figures, net interest income (the spread between deposit and lending rates multiplied by volume of money lent) for China's 'Big Four' state-owned banks – Industrial and Commercial Bank, China Construction Bank, Agricultural Bank of China and Bank of China – amounted to US$66 billion, US$56 billion, US$54 billion and US$41 billion respectively. In terms of net interest income of all banks in the world, this placed these banks first, second, third and eighth respectively.[33] The point is that the easy profits generated by these banks from operations within a highly protected and regulated political economy is poor preparation for these banks when it comes to competing in financial environments such as the one they face in Singapore.

Looking Ahead: The Future of China-Singaporean Financial Relations

In March 2013, the PBoC announced that Singapore would be the first centre outside China to have a yuan-clearing bank for offshore business in the RMB. The Industrial and Commercial Bank of China was chosen as the official clearing bank. According to reports, the announcement is an important step for firms based in Singapore to play a leading role in promoting the use of the RMB globally. It will ensure an important role for Singapore in "creating deep, liquid and efficient renminbi-denominated deposit, bond, equity, currency, commodity and derivative markets for investment, risk management and risk transfer purposes…"[34]

[33] See "Too big to hail," *The Economist*, August 31, 2013: http://www.economist.com/news/leaders/21584342-chinas-banking-behemoths-are-too-beholden-state-it-time-set-finance-free-too-big accessed June 24, 2014.

[34] Joseph Cherian, "Yuan clearing bank a plus for Singapore," *The Business Times*, March 19, 2013: http://bschool.nus.edu/Portals/0/images/CAMRI/News/Business%20Times%20-%20Yuan%20clearing%20bank%20a%20plus%20for%20Singapore%20-%2019%20Mar%202013.pdf accessed June 25, 2014.

Other announcements have caught the public's eye. For example, in July 2014, the People's Bank of China officially announced its decision to allow companies and individuals in the Sino-Singapore Tianjin Eco-city (SSTEC) to conduct cross-border renminbi-denominated transactions with financial institutions in Singapore.[35] But these agreements should be placed in the context of the rapidly growing but still relatively small-scale and non-dominant nature of Chinese financial and investment transactions with Singapore. While such agreements do create some new opportunities for Singaporean and Chinese firms in each other's economies (especially in China since these special zones entail the partial liberalisation of some sectors to outside investors), they are largely facilitative agreements that are designed to enhance the ease of commercial interaction and to reduce transaction costs. But they do not transform China into a fundamentally more attractive financial and investment partner of Singapore's than China is currently.

Instead, the future significance of renminbi-denominated financial activity in Singapore depends on the future significance of RMB as a regional and global currency. Over RMB 60 billion was cleared in the first month of the ICBC's operation as a clearing bank in Singapore.[36] By April 2014, Singapore overtook London as the largest clearing centre for the RMB outside China and Hong Kong; with the value of RMB payments increasing 375 per cent between March 2013 and March 2014.[37]

[35] "New Developments in Tianjin Bring fresh Opportunities to Singapore companies," *International Enterprise Singapore Media Release Mr. No. 029/14*, July 30, 2014 http://www.iesingapore.gov.sg/~/media/IE%20Singapore/Files/Media%20Centre/Press%20Releases/7th20STETC20meetingPress20Release30Jul14final202.pdf accessed August 12, 2014.

[36] See "Over 60 Billion Cleared Through Yuan Clearing Bank in Singapore in the First Month of Operation," *ICBC News*, July 17, 2013: http://www.icbc.com.cn/icbc/newsupdates/icbc%20news/Over%20RMB%2060%20Billion%20Cleared%20through%20Yuan%20Clearing%20Bank%20in%20Singapore%20in%20the%20First%20Month%20of%20Operation.htm accessed June 25, 2014.

[37] See Katie Holliday, "Singapore becomes yuan's largest offshore clearing center," *CNBC*, April 28, 2014: http://www.cnbc.com/id/101618190 accessed June 25, 2014.

However, these impressive sounding numbers need to be placed in proper perspective. Despite China's economic size and role in regional and global trade, the role of the RMB in global finance is tiny.

As Table 7 shows, the importance of the RMB in global transactions is extremely slight. Despite rapid growth in the use of RMB in global transactions, mainly to settle some trade interactions that have been facilitated by some twenty-three currency-swap agreements with China, payments in RMB still only accounted for 1.62 per cent of global payments in March 2014. In the same period, the U.S. dollar accounted for 40.19 per cent of global payments and the Euro 31.78 per cent.[38]

To be sure, so-called 'swap agreements' with the PBoC will become more important. China conducts the majority of its trade in American dollars, and a small percentage in Japanese yen. In 2012, RMB was

Table 7: Leading Global Currencies in Foreign Exchange Transactions, June 2011

Rank	Currency	Share of FX (%)	Share of FX / Share of GDP (%)
1	USD	45.9	197
2	EUR	16.9	87
3	JPY	6.8	79
4	GBP	5.8	162
5	AUD	3.7	189
6	CHF	2.9	348
7	CAD	2.4	94
8	SGD	1.6	446
14	RMB	0.9	9

Source: SWIFT figures.

[38] As above.

used in only fifteen per cent of China's imports and nine per cent of its exports.[39] (This is in contrast to the U.S. where ninety per cent of its trade is in U.S. dollars and Japan where seventy per cent of its trade is in Japanese Yen.) This means that a local currency needs to be converted to the greenback, and then into RMB (and vice versa) when trading with China. The extra cost of intermediary conversions to and from the U.S. dollar in IOUs increases the transactions costs of trade, and precludes businesses from hedging against rises or falls in the American dollar. It also carries the additional risk of a liquidity crunch during transactions with China should American dollars be in short supply in the future, even though the prospect of this is minimal for the moment.

To minimise transaction costs and other settlement risks, the PBoC has signed over twenty currency-swap agreements with central banks of major trading partners. These agreements differ in the maximum amount of currency available for the swap. They also vary as to whether the direct swap applies to the principal or only the interest payment of any IOUs from bilateral trade. But the point of these agreements – besides providing central banks with a buffer against possible shortages in American dollars required for trade with China – is to establish a future foundation for importers and exporters to exchange RMB with local currency without having to sign IOUs that are denominated in American dollars.

While the vast majority of payments and settlements in RMB are in the context of trade activity, the emergence of Singapore as a clearinghouse for RMB is intended to be more meaningful and extensive than merely facilitating more efficient payments for trade transactions. In addition to utilising swap agreements as described above – with the limit currently set at S$60 billion – the prospect is that Singapore can emerge as a global

[39] See Arthur Kroeber, China's Global Currency: Lever for Financial Reform (Washington DC: Brookings-Tsinghua Centre for Public Policy February 2013), pg. 3: http://www.brookings.edu/~/media/Research/Files/Papers/2013/04/china%20global%20currency%20financial%20reform%20kroeber/china%20global%20currency%20financial%20reform%20kroeber.pdf accessed June 25, 2014.

financial centre to buy, sell and 'park' RMB-denominated assets whether they be bonds, shares, IOUs or other assets. This would increase the importance of Singapore in regional and global transactions involving RMB-denominated assets, help enhance the internationalisation of the RMB as a genuine global currency, and more intimately link Singapore's financial system to the Chinese economy.

Yet, while the RMB is used in increasing but still small amounts as a medium of exchange in settling trade transactions and cross-border investment transactions which are still at relatively low levels despite the raft of facilitative agreements concluded or being considered, it has virtually no international status as a 'store of value' for central banks to accumulate in official reserves or as an investment currency for use outside China. Besides using RMB to settle trade invoices, currency speculators also periodically buy RMB (through illicit use of the trade account and other methods – otherwise known as 'hot money') on the prospect that the RMB will be partially liberalised and rise in value. But until the RMB is seen as a legitimate and reliable store of value, international demand for RMB will not match the top five or six currencies, meaning that the RMB will have limited relevance and penetration in financial centres such as Singapore beyond trade purposes.

The genuine internationalisation of the RMB is unlikely to occur for a number of reasons. First, China still maintains a *de facto* fixed currency regime linked to a U.S. dollar-dominated 'basket of currencies.' Until this is changed, there is little incentive to hold too many assets and IOUs in RMB since the prospect of dramatic appreciation in the value of China's currency is slight. Bear in mind that Beijing places significant restrictions on the band within which conversion rates utilising swap arrangements can deviate from official, fixed conversion rates for RMB into U.S. dollars.

The prospect for dramatic change in China's fixed currency regime is also poor. China's two largest export markets, i.e. America and the E.U., are still deleveraging and will grow relatively slowly; and the margins of its exporters are increasingly suffering from competitors in rising Asian manufacturing hubs such as Vietnam, Cambodia and Indonesia. To protect an export-manufacturing sector that employs fifty million people directly and another 100-150 million people indirectly, Beijing will not float the RMB and allow it to significantly appreciate into the future. Besides, rapid appreciation of the RMB against the U.S. dollar would severely reduce the value of its U.S. dollar-denominated foreign exchange reserves and dramatically increase the liabilities of the PBoC vis-à-vis IOUs issued to domestic banks on behalf of exporters as explained earlier.

Second, foreign governments, firms and individuals will remain reluctant to hold too much RMB-denominated assets for the simple reason that there is not much use for the currency outside China (and Hong Kong where its status as the leading clearing hub for the renminbi is largely used by foreign firms as an entry point into mainland China, by Chinese firms as an entry point out of China, and by Beijing as a 'control testing ground' for renminbi internationalisation.[40]) This will remain the case until China opens its capital account, liberalises its domestic interest-rate regime (i.e., deposit and lending rates), and removes obstacles currently in place to restrict the presence and operation of foreign firms in Chinese financial and other domestic sectors.

Without an open capital account, foreign holders of RMB-denominated assets will not be able to transfer capital in and out of China freely and without restriction. Without a liberalised interest rate regime, deposit and lending rates in China will remain artificially suppressed, decreasing the incentive to 'park' capital inside China. Without being able to invest freely and openly in major domestic sectors of the Chinese economy, there will be limited utility and therefore demand for RMB-denominated assets for investment purposes. Due to Beijing's

[40] See Neil Daswani and Michael Vrontamitis, " Hong Kong Won't Be Sidelined By New Renminbi Centres," *Standard & Chartered Research Note* https://www.sc.com/en/resources/global-en/pdf/Research/HK-RMB-Centre.pdf; Simon Rabinovitch, "Cities compete to be global centre of renminbi trading," *Financial Times*, October 29, 2013 http://www.ft.com/intl/cms/s/0/b7ea287c-4066-11e3-bd57-00144feabdc0.html#axzz3A9hj4fTx; Michelle Chen and Xiaowen Bi, "Hong Kong should cherish its standing as offshore yuan hub – China c. bank," *Reuters*, July 3, 2014 http://www.reuters.com/article/2014/07/03/hongkong-protests-yuan-idUSL4N0PE0N320140703 all accessed August 12, 2014.

determination to maintain the dominance of its state-owned banks in the domestic financial sector, corporate bond markets within China will remain relatively undeveloped, meaning that RMB fixed-income options will remain shallow and relatively illiquid compared to other major currencies.

Finally, a point should be made about financial flows generated by tourism, which is gaining significant interest. In the first half of 2013, 1.24 million Chinese tourists visited Singapore, a 27 per cent rise from the same period from a year before.[41] Once again, such numbers need to be placed in context when it comes to discussion about Chinese financial penetration. Even though Chinese visitors have overtaken Indonesians as the biggest spenders in this sector, Chinese spending was still only S$1.52 billion in that record six months. In other words, one should not overplay the role of Chinese tourism as a driver of financial flows in the country.

CONCLUSION

In contrasting the lack of RMB financial penetration now and in the foreseeable future with the U.S. dollar, we are really contrasting the two countries' political economy. Unlike China, the U.S. has an open capital account, a liberalised interest-rate regime, an open and welcoming investment regime for foreigners in most sectors of the economy, and has deep and sophisticated government and corporate bond and other fixed income markets. The U.S. also has far superior institutions that build confidence in assets denominated in its currency such as rule-of-law, strong laws protecting property and intellectual property rights, and far superior reserves and generators of intellectual and human capital that is attractive to international investors.

[41] See Melissa Lin, "Chinese tourists are top spenders in Singapore," *Straits Times*, February 9, 2014 http://www.asianewsnet.net/Chinese-tourists-are-top-spenders-in-Singapore-56902.htm For an analysis of Chinese tourism spending globally, see "China's Outbound Tourism," Integreon Research, May 2014 http://www.grailresearch.com/pdf/ContenPodsPdf/2014%20China%20Outbound%20Tourism%20Market.pdf both accessed August 12, 2014.

The point is that until there are deep, lasting and irreversible reforms to the Chinese political economy – and there is little evidence of that happening so far – the role of the RMB in regional and global financial markets will be far smaller than it could be given the size of the Chinese economy. In other words, the much-lauded 'capitalism with Chinese characteristics' is preventing China from becoming a global financial player commensurate with its absolute size. This is not to deny that the emergence of Singapore as a leading RMB clearinghouse is a win-win for Singapore and China, as it will undeniably broaden the role of Singapore as a regional and global financial hub. But it is far from a prelude to significant Chinese financial penetration of the Singaporean economy, or the Singaporean financial sectors in particular.

More generally, and far from creating political and strategic vulnerabilities for a small-city state, Singapore's economic openness, institutional strengths and subsequent role as a leading financial hub is a strength. This role is an economic boon for the country, which also ensures that Singapore's financial sector – and sources of finance for the domestic economy – is not overly reliant on any one country or region.

Indeed, the continued status of Singapore as a leading financial centre enhances the country's importance and relevance to all the leading economies of Asia, North America and Europe – without the city-state being dangerously bound to any single one. This is highly consistent with Singapore's desire to maximise political and strategic autonomy vis-à-vis a rising China.

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