The Dim Sum Bond Market in Hong Kong

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THE DIM SUM BOND MARKET IN HONG KONG

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Abstract

The Dim Sum bond market in Hong Kong, which allows China to regulate the amount of offshore yuans that flow back into the mainland, has grown steadily since its inception in 2007 and is expected to surpass in 2013 the threshold level that would attract insurers and long term issuers to the market. Yet, the market has not matured sufficiently relative to the yuan deposit market in Hong Kong that has grown at a much faster pace on account of trade liberalization and the use of yuans in China’s international trade settlements. Even though Hong Kong has fulfilled its role as an offshore currency center for the yuan, it is being challenged by Taiwan, Singapore and London in terms of being the premier location for the issuance of yuan denominated bonds outside of Mainland China.
1.0 Introduction

Whether a country with supernormal economic growth prospects but with underdeveloped financial markets can deflect the rising demand for its currency and for unrestricted entry into its domestic capital markets by creating a highly-regulated offshore center for its currency is currently being put to the test in Hong Kong. The yuan denominated bond market in Hong Kong, also known as the Dim Sum bond market or the Renminbi (RMB)\(^1\) bond market, enables nonresidents of China – who are usually barred \(^2\) from participating in China’s onshore bond markets,- to invest in yuan-denominated bonds, issued by a select group of pre-screened entities and financial institutions, outside of China. This bond market, which allows accumulated offshore yuans to flow back into the Mainland under strict regulatory controls, was initiated in 2007 as part of China’s multi-faceted plan to begin internationalizing the yuan, launch a platform that would enable China to leverage Hong Kong’s superior financial infrastructure (Chen and Cheung, 2011; Fung and Yau, 2012) and gradually liberalize its capital account (Eichengreen, 2010).

China is relying on Hong Kong’s relatively superior financial infrastructure to develop its offshore capital market which will eventually be fully integrated with its domestic financial markets in the Mainland.

In recent years, large amounts of Chinese yuans have moved offshore as China implemented a sequence of measures to liberalize its current account and encourage settlements with its trading partners in yuans instead of the U.S. dollar (Sekine, 2011). Specifically, as (a) proportionately more bilateral trades between China and its Asian and Latin American trading partners have been transacted in yuans instead of U.S. dollars, (b) China invested in infrastructure projects around Asia, Latin America and Africa through its sovereign wealth funds, and (c) Mainland Chinese tourists spent record amounts of

\(^1\) The Renminbi, known in its abbreviated form as RMB, is the official currency of the Peoples Republic of China but not of Hong Kong or Macau. The supply of RMB is determined entirely by monetary authorities in China. Like the Federal Reserve in the United States, which determines the supply of U.S. dollars to the global economy, it is the Peoples Bank of China that determines and controls the supply of RMBs; yuan is the unit of account.

\(^2\) For the most part, nonresidents are not permitted to participate in domestic bond markets in Mainland China; only a handful of financial institutions are allowed to do so.
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yuans abroad, mainly in Hong Kong, the amount of offshore yuans seeking investable outlets have increased steeply over the years.

China has the unique advantage of being a nation with two systems: the relatively restrictive, government-controlled regime in the Mainland and the free, market-based economic environment in Hong Kong. Even though it lacks at the moment the financial sophistication in the Mainland to permit full and unrestricted internationalization of its currency, China can utilize the platforms in Hong Kong to phase in its financial strategies gradually, thereby affording for itself time to upgrade the financial systems in the Mainland.

China has allowed increasing numbers of entities to issue bonds in the Dim Sum bond market and officially move the offshore RMBs onshore via enhanced channels. Prior to October 2011, only companies outside of Mainland China, multinational agencies and financial institutions in China could issue Dim Sum bonds in Hong Kong without prior approval from regulatory agencies in China; beginning October 2011, companies domiciled in China can also issue yuan-denominated bonds in Hong Kong and repatriate the yuans into the Mainland if they satisfy the preconditions for such transfers. In March 2013, the China Securities Regulatory Commission (CSRC) expanded the scale and scope of the Renminbi Qualified Financial Institutional Investor (RFQII) program, which was launched in December 2011, to allow foreign financial institutions, Hong Kong subsidiaries of Mainland commercial banks and insurance firms and Hong Kong domiciled financial institutions to participate in the onshore RMB market. Clearly, China appears to be supplying the world with increasing amounts of offshore yuans on the one hand and creating on the other enhanced mechanisms of entry, albeit regulated, for these offshore yuans into the Mainland.

Yet, the Dim Sum market remains small in its capacity to absorb all the yuans that have moved offshore due to enhanced trade settlements in yuans. It is small not because holders of RMBs are using other channels to move money onshore. It is small because the number of institutions issuing bonds in this market is not expanding as expected. The prevalence of strict oversight as to how the offshore RMBs
can flow back into the mainland is discouraging major institutions and corporations from issuing longer
term bonds on a large scale in the Dim Sum bond market.

The object of our study is to evaluate the performance of the Dim Sum bond market since its
inception, both in absolute terms and in relation to the measures that have been taken to promote the
market and generate international interest in RMB bonds via the platform in Hong Kong. Despite being a
smaller market for bonds than in the Mainland, the Hong Kong bond market for RMB bonds was
projected to be the preeminent offshore center for the Chinese currency and RMB bonds. Whether Hong
Kong has fulfilled its intended role as the center for RMB bonds to date will be explored in our study.

We find that even though the Dim Sum bond market has grown appreciably since its inception in
2007 and is expected to surpass the critical threshold of $25 billion in 2013, the market is not absorbing
an increasing proportion of the RMB deposits which have accumulated in Hong Kong on account of
enhanced levels of trade settlements in RMBs and RMB spending in Hong Kong. The ratio of RMB
bonds to RMB deposits in Hong Kong was the same in 2012 as it was in 2009. On the other hand, RMB
holders have shown a preference for time deposits in Hong Kong, which have been growing at a much
faster pace since 2007. Also, the majority of issues in the Dim Sum bond market have maturities less
than five years. Even though investors were willing in the past to accept lower yields in anticipation of
currency related gains when the yuan appreciated, they have demanded since December 2012 higher
yields and rated bonds on the Dim Sum market as the expectation that the yuan can only move up has
weakened substantially. The expectation that the yuan can fluctuate is eventually good for the Dim Sum
bond market since nobody would like to borrow in a currency that will only appreciate with time.

We review in section 2 the economic and environmental circumstances that prompted Chinese
authorities to inaugurate the Dim Sum bond market in Hong Kong. We provide a detailed review of the
RMB bond market, emphasizing (a) the origins of the RMB bond market in Hong Kong, and (b) the
drivers of current and future growth in the RMB bond market. The actions of the regulatory authorities in
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terms of expanding the scale and scope of trade settlements in yuan, permitting an enlarged set of institutions and entities to issue bonds in the Dim Sum bond market and opening up at the same time additional channels by which offshore yuans can flow back into the Mainland are documented and their effects on the Dim Sum bond market are explored. In section 3, we analyze the performance of the Dim Sum bond market since its inception, both in absolute terms and relative to the bond markets in the Mainland and in Hong Kong. In Section 4, the pivotal role Hong Kong has played so far in promoting the RMB bond market is explored and we examine the question whether Hong Kong can continue to serve as the nerve center for the RMB bond market. Section 5 of the paper concludes.

2.0 Origins of the Dim Sum bond market

The Dim Sum bond market was inaugurated in January 2007, well before the global financial crisis struck in August of 2008. As a direct consequence of the post-1997 Asian crisis initiatives to increase the resiliency of nations to foreign currency crises, bond issuances in Asian nations were on the rise since 2000. Domestic and foreign entities were being encouraged to participate in both the Asian local currency and Asian foreign currency bond markets (Hesse and Dalla, 2009; Goswami and Sharma, 2011). The Asian bond market has grown steadily since the 1997-98 crisis until 2009 when it dipped due to the global financial crisis, but steeper growth rates commenced in 2010 and record levels of bonds have been issued by Asian nations since then (Shim, 2012).

In particular, rising global demand for Asian bonds, increasing bond issuance in ASEAN countries, enhanced foreign participation in Asian local currency bond markets amidst declining preference for G3 bonds, and greater share of bonds vis-à-vis stocks in global portfolios were the principal forces driving the growth in Asian bond market (Eichengreen, 2006). China’s liberal policies with regard to its current account that led to a much-enhanced supply of yuans in offshore markets and the concurrent events in the Asian bond market convinced Chinese authorities to begin an offshore market for

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3 The active phase of the crisis, which manifested as a liquidity crisis, began on August 9, 2008, when BNP Paribas terminated withdrawals from three hedge funds citing "a complete evaporation of liquidity."
4 G3 bonds are bonds denominated in U.S. dollars, Euro and the Japanese yen.
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yuan denominated bonds. Lacking the necessary financial infrastructure in the Mainland to support both unrestricted capital inflows and unregulated participation by foreigners in its local currency bond markets, China opted instead to implement a controlled experiment in Hong Kong, hoping that the Dim Sum bond market will permit the Chinese authorities to regulate the amount of yuans that will move back into the Mainland from the pool of yuans which have flown, and will continue to flow in increasing amounts, out of China as a result of a step up in its current account liberalization policies since 2001.

To be on par with trends in other Asian nations, restrictions on the issuance of yuan-denominated bonds by the Chinese subsidiaries of foreign banks in Hong Kong were formally lifted by the State Council in January 2007. Financial entities in Mainland China were allowed by the Peoples Bank of China and the National Development and Reform Commission to issue RMB-denominated bonds in Hong Kong. The decision by the State Council of the Peoples Republic of China in January 2007 to allow banks headquartered in the Mainland to issue in Hong Kong bonds denominated in RMB was the first official measure implemented by China to permit nonresidents to hold RMB-denominated bonds issued outside the Mainland. Named as “Dim-Sum” bonds, these RMB bonds issued in Hong Kong have allowed holders of RMB outside of China to invest in RMB denominated bonds issued in Hong Kong by banks, corporations and government institutions. This marked the beginning of a new, emerging market for RMB bonds, miniscule at that moment compared to the local and foreign currency bond markets both in Hong Kong and Mainland China, but with a potential to become even larger than the Euro yen bond market in Asia in the years ahead. First issue of RMB bonds by a financial institution in the Mainland were undertaken in June, 2007 when China Development Bank issued the first yuan currency bond outside Mainland.

The chronology of policy measures implemented by Chinese authorities detailed in Appendix A would indicate that the Dim Sum bond market was not launched to take advantage of the crisis in developed economies. Rather, the Dim Sum bond market was started to herald China’s commitment to its ‘one nation two systems’ goals and to begin an offshore bond market in Hong Kong in light of what
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was then happening in Asia. However, as our analysis in section 3 would demonstrate, the Dim Sum market grew rapidly only after the Chinese authorities extended the scale and scope of use of yuans in trade settlements in 2011 and the supply of offshore yuans increased appreciably to fuel the growth of the Dim Sum bond market.

2.1 Current account liberalization, increasing supply of offshore yuans and the growth of the Dim Sum bond market.

China announced a 4 trillion RMB ($586 Billion) fiscal stimulus package in November 2008 and in December 2008, eligible Mainland and Hong Kong enterprises were permitted to use Renminbi to settle trade transactions. Restrictions on the issuance of yuan-denominated bonds by the Chinese subsidiaries of foreign banks in Mainland China were formally lifted by the State Council in December 2008. In April 2009, Sate Council decided to introduce a pilot scheme for using Renminbi in cross border trade settlements and allowed Hong Kong banks to issue RMB bonds, and in May 2009, Shanghai City government confirmed the lifting of the restrictions on the issuance of yuan-denominated bonds by the Chinese subsidiaries of foreign banks in Mainland China.

By June 2009, scope of trade settlements in RMB was greatly enhanced. China’s State Council decided to use RMB in cross-border trade settlement as part of its long-term plan to globalize its currency and reduce the domination of the US dollar. The scheme only applied to dealings with 450 designated Chinese enterprises in five cities — Shanghai, Shenzhen, Guangzhou, Dongguan and Zhuhai. Outside the Mainland, it was open only to 10 ASEAN nations, Hong Kong and Macau. By the end of 2010, the number of approved Mainland Designated Enterprises (MDE) – companies which could settle both exports and imports in RMB – was expanded to 67,359 from 365; a non-MDE could only settle imports in RMB. Within a year, China would sign a momentous agreement with Japan. By December 2011, PBoC announced policies to promote the use of RMB in trade and financial settlements between China and
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Japan; Japan became the first developed economy to hold RMB bonds as reserve assets.\(^5\) By the end of 2011, China had committed itself irrevocably to internationalizing its currency and had taken the all-important step of convincing a major developing nation, Malaysia, to hold RMBs as a reserve currency.

Liberalization of current account transactions requires China to open up bilateral swap lines for RMBs with its major trading partners. China should be prepared to provide RMBs should there ever be a scarcity of RMBs in global financial markets to settle terms of trade. But China’s swap lines with its trading partners are heavily underutilized to say the least. Of the 21 swap lines China has opened as of July 2013, only a few nations have drawn on their balances since China runs a deficit with most of its trading partners in the developing economies. China, on average, buys more from its Asian trading partners than its sells to them. As such, with each instance of enhanced trade liberalization only more RMBs accumulate in offshore markets. In the near future, with enhanced liquidity in offshore yuan markets, one would expect the Dim Sum bond market to play even a greater role in allowing the offshore yuans to flow back into the Mainland.

For all practical purposes, the capital account of China remains closed. More importantly, the access to the onshore debt market is closed to nonresidents. Foreign institutions, with the exception of banks, are barred from participating in the onshore bond markets. RMB market in Hong Kong provides a way out of this problem. With regulated policies, holders of RMB-denominated assets in Hong Kong will be able to get access to onshore RMB accounts. Corporations in Hong Kong are now permitted to issue bonds in onshore markets of China and companies in Mainland China are now allowed to issue Dim Sum bonds in Hong Kong and repatriate the funds onshore. Nevertheless, the ultimate growth of the Dim Sum bond market will depend on the ability of issuers to invest the RMB proceeds directly and freely in Mainland China since investment opportunities are growing fastest there. Presently, RMBs raised in Hong Kong can be invested in China if the investments are in form of foreign direct investments and

\(^5\) As of December 2011, China was Japan’s biggest trading partner ($340 billion by value)
equity, approved by the authorities. Clearly, the RMB bond market cannot grow to its potential if such restrictions remain in force. With more RMBs leaving China on account of current account liberalization and China’s sovereign investments in other nations, pressures to liberalize the flow of RMBs into the Mainland will only intensify in the years ahead.

2.2 The sources of future growth in the Dim Sum bond market

Standard Chartered Bank (Special Report, 2011) has projected that annual settlement in RMB will total $1 Trillion by 2015. Imports account for 80% of RMB trade settlement and they represent an increasingly important source of RMB migration from onshore to offshore. Additionally, China is pushing to replace dollar invoicing by RMB invoicing for its trading partners in Asian, African and Latin American markets in the years ahead. Emerging markets which often use U.S. dollars to settle terms of trade, are expected to go along with these measures as their trade with China increases in the future.

The China ASEAN Free Trade Area (CAFTA), signed in November 2004 to develop a free trade area between China and ASEAN nations, went into effect January 1, 2010 for six nations – Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand. The remaining four nations, Myanmar, Cambodia, Laos and Vietnam, will join CAFTA in 20156. China is slowly but steadily displacing the United States as a major trading partner of ASEAN nations. In addition to providing trading privileges to the member nations, CAFTA is committed to imparting a fair investment mechanism for investors from both sides. Chinese companies investing in ASEAN countries can also enjoy most favored nation (MFN) treatment. In addition, China is investing in infrastructure projects in Africa and Latin America and providing infrastructure assistance to developing and emerging economies using RMBs as the transaction medium. Such practices will allow greater migration of RMBs out of Mainland China and these financial innovations will have benevolent consequences for the RMB bond market in Hong Kong as more offshore yuans migrate to Hong Kong. RMB deposits in Hong Kong are expected to grow to a level of

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6 According to the ASEAN Secretariat, trade between ASEAN nations and China grew at a rate of 20% annually between 2003 and 2008, and China’s trade deficit with ASEAN nations soared to $7.5 billion in the first seven months of 2010. For the same period, trilateral trade between China and ASEAN members rose to $161 billion – a 50% increase year to year.
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$800 billion by the end of 2015, according to Standard Chartered Bank – one of the three principal banks responsible for developing the RMB bond market in Hong Kong.

Another important determinant of the growth of RMB-denominated markets in Hong Kong is the pressure on Chinese firms to go global and develop centralized treasury centers in selected regions around the world. Chinese companies have lagged behind some of their peers in Korea and Japan but there has been a sea change in the international strategies of Chinese firms beginning 2010. Chinese companies in the energy, resources and telecommunications sectors have been more open to going abroad and they have selected Hong Kong, Singapore and Dubai as international treasury center locations. The strong demand for Chinese imports in the US will always make it a prime location for expansion but Chinese companies have chosen these three locations for treasury management functions for the moment and it is not unreasonable to expect that Hong Kong will continue to be the central location for offshore RMBs. Therefore, the influx of RMBs into Hong Kong may usher in new paths of intermediation that will only benefit the Dim Sum Bond market in the future.

2.3 Flows of Offshore RMBs into the Mainland and the role of the quota system

Current rules allow money to enter and leave China freely as long as it is backed by trade documents. As noted earlier, China has been fairly liberal with regard to its current account since the mid-1990s. Further, it had to agree to several relaxations with regard to banking transactions in order to get admission to the World Trade organization in 2001. But the situation is quite different when currencies have to be exchanged and converted. Offshore participating banks are allowed to purchase RMB from their onshore counterparts for purposes beyond trade settlement subject to quota and other regulatory constraints. China maintains strict administrative controls on this channel of currency flows in and out of Mainland China. A quota system is in force, but in February 2010, the Hong Kong Monetary Authority (HKMA) permitted banks in Hong Kong to develop new RMB-based business models as long as the money did not flow back to the Mainland. This has led to freer circulation of RMB in Hong Kong
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and has resulted in the growth of several RMB instruments and markets, especially the Dim Sum bond market.

On the other hand, there are other forces which fuel the accumulation of RMB deposits in Hong Kong. Exporters to China who received settlement in RMB and merchants in Hong Kong who are recipients of tourism-related RMBs tend to keep the RMB offshore and not return to the onshore banks. Such tendencies resulted in offshore banks overshooting their quotas for RMB transactions unrelated to trade very quickly and the deposits in Hong Kong rising very rapidly.

While HKMA responded to this trend by raising the quota for RMB transactions for offshore banks in Hong Kong, Mainland Chinese authorities allowed more companies in China to settle exports and imports in RMB, adding only to the buildup of RMBs offshore which were gradually being reflected in the burgeoning RMB deposits in Hong Kong. While the Dim Sum bonds provided an outlet for these deposits to a degree, the major destination of these flows were time deposits with banks in Hong Kong. China has limited the number of offshore access points to onshore markets with active deliberation and has entrusted Hong Kong to develop, promote and extend the RMB business globally. In effect, China is conducting a controlled experiment through Hong Kong, which is a reputed international financial center capable of ushering in financial innovation and tapping international capital markets for the ultimate benefit of China. The HKMA has world-class clearing and settlement systems already in place and is in a position to deal with an expanded set of RMB products.

For the foreseeable future, it would seem that all RMB flows into and out of China will be governed by a quota system or a case-by-case regulatory approval. The quotas may be periodically raised to match demand to a degree but it is readily evident that China would maintain the quota system as it liberalizes its capital account gradually over the years. Authorities in China have signaled that full convertibility of the RMB will be phased in gradually and expansion of the RMB market will be attempted with controls in place. Full convertibility of the RMB is not a necessary condition at the
moment for the RMB market to grow but there will come a time the absence of full convertibility will hinder the growth of the RMB market. The Dim Sum bond market is case in point. If this market is to attract foreign issuers intent on raising RMBs that can be used to finance their expansions in Mainland China, the offshore RMB will have to be fully convertible to onshore RMBs. In addition to comparing liquidity, spread and pricing, foreign issuers will also consider the ease with which RMBs raised offshore can be repatriated to onshore. Despite recent relaxations, several restrictions still remain in force.  

3.0 The RMB market in Hong Kong vis–a–vis local and foreign currency bond markets in Mainland China and Hong Kong: A comparative analysis

The size of the RMB bond market has grown from $1.34 billion in 2007 to $23.85 billion at the end of 2012 and up to $18.48 billion for the eight months ending August 2013. On the other hand, total RMB deposits in Hong Kong have ballooned from $1.5 billion in 2004 to $95.6 billion in 2012 and to $112.8 billion by the end of June 2013. The number of banks engaged in RMB related business has grown from 39 in 2008 to 140 in 2013. The deposit base was only $9.2 billion at the end of 2009. The phenomenal increase in the deposit base since 2009 is attributable to China’s decision in December 2008 to allow eligible Mainland and Hong Kong enterprises to use Renminbi in trade settlements. The RMB bond market which was only $6.15 billion in 2010 rose almost fourfold to $23.60 billion in 2011. This increase can be attributed to the increased supply of offshore RMBs on account of trade liberalization policy measures implemented by China in 2010. The RMB bond market capitalization to RMB deposit ratio, which was 25.47% at the end of 2009, receded to 13% at the end of 2010, has risen back to 24.96% by the end of 2012. Evidently, the RMB deposit base in Hong Kong has grown at a rapid rate and the

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7 The reforms of October 2011 have made repatriation of offshore funds easier but authorities in China still insist on retaining both regulatory and supervisory powers over fund flows into the Mainland over a statutory limit. China announced its policies with regard to RMB FDI effective October 13, 2011, expanding on its policies for U.S. dollar FDI flows already in place. Any application for RMB FDI valued at or above RMB 300 million ($47 million) must be submitted to the Ministry of Commerce for prior approval. Amounts below RMB 300 million need not be. FDI investments in securities and derivatives investments are still prohibited but foreign investors are allowed to participate in private placements of publicly listed companies subject to approval by the Ministry of Commerce. RMB funds for M&A activities will have to be approved by the Ministry of Commerce. These actions open up new channels of flow for offshore RMB into onshore in many ways and bode well for the offshore RMB market.
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RMB bond market has been able to absorb only a small fraction of the RMBs circulating in Hong Kong. Holders of RMBs in Hong Kong have shown a preference for RMB-denominated deposits, especially for time deposits, which have increased from $0.8 billion in 2004 to $112.76 billion by June 2013. As a proportion of total RMB deposits in Hong Kong, time deposits have risen from 55.35% in 2004 to 81.73% at the end of June 2013.

The amount of RMB bond issuance in 2013 is expected to exceed $25 billion – a size deemed by experts to be large enough to draw pension and insurance funds to the market. The market for the bonds is still small but the interest it is generating among major issuers holds the key to its future potential growth. The range of issuers has expanded over time, from Mainland financial institutions at the beginning to the Chinese Ministry of Finance and the Mainland subsidiaries of Hong Kong banks in 2009, and eventually to Hong Kong-based and multinational corporations and financial institutions in 2010.\(^8\) With the entry of Chinese companies to the Dim Sum bond market in October 2011, the growth in this market is expected surpass prior records. The maturity of issues has lengthened from 2 to 3 years to 10 years in 2010 but the maturity for majority of bond issues in the Dim Sum market is less than three years (Fung and Yau, 2012). According to data compiled from Thomson One, investors are demanding more rated bonds than ever before and the yields on Dim Sum bonds since December 2012 have risen since the expectation that the yuan will only rise in the future has weakened substantially since the beginning of 2013.

Table 1 lists some important financial variables pertaining to China and Hong Kong for the years 2007 and months in 2013 for which the latest data are available for the variable(s). From Table 1, we have noted that holders of RMB in Hong Kong prefer to hold time deposits. For the three classes of foreign currency deposits in Hong Kong for the time period under review, foreign currency time deposits

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\(^8\) To date, apart from the Ministry of Finance, the issuers that have issued or launched RMB bonds in Hong Kong included China Development Bank, China Export and Import Bank, Bank of China, Bank of Communications, China Construction Bank, HSBC (China), Bank of East Asia (China), Honeywell Highway Infrastructure Limited, McDonald’s, Asian Development Bank and International Finance Corporation.
comprise the largest proportion of the foreign currency deposit base even though they have shown the
slowest rate of growth. Thus, the preference among RMB holders to hold time deposits is in accordance
with the typical characteristic of Hong Kong’s foreign currency deposit holders.

As of June 2013, the foreign currency bond markets in China and Hong Kong were of
comparable sizes but the local currency bond market in China is approximately 23 times the size of the
corresponding market in Hong Kong. Despite Hong Kong’s financial sophistication, the size of its local
currency bond market is indeed very small compared to that of China’s. Also, since the time China
floated the Dim Sum bond market in Hong Kong, China’s foreign currency bond market has expanded by
more than 356 percent and Hong Kong’s by 190 percent. It would seem that even though China is very
conservative about offshore yuans moving in onshore, it has encouraged foreign currency bond issuance
in the Mainland and the size of the market in China has surpassed that of Hong Kong’s as of June 2013.
Foreign currency bond issuers have preferred Mainland China over Hong Kong even though Hong Kong
is deemed to be financially more open and sophisticated than the Mainland.

Cross border trade in Renminbi was initiated in Hong Kong in September 2010. As of June 2013,
total remittance of the Renminbi for cross border trade purposes has expanded by 870 percent and
amounted to $43.75 billion, which is far less than the total RMB deposits in Hong Kong ($112.76 billion).
Thus, it is likely that offshore RMBs from places other than Hong Kong are moving to Hong Kong.
Offshore RMBs can either be held as deposits in Hong Kong, invested in Dim Sum bonds, repatriated
onshore through regular channels, extended as loans to entities onshore or swapped into other currencies.
The size of the RMB deposit base in Hong Kong, in relation to the cross border trade settlement amount,
point to the possibility that Hong Kong residents are converting a substantive amount of Hong Kong
dollars into RMBs and holding them as RMB deposits in Hong Kong. Residents of Hong Kong are
permitted to convert 20,000 Hong Kong dollars per day to RMBs in Hong Kong.
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However, a recent report from the Bank of International Settlements\(^9\) notes that the RMB has overtaken the Hong Kong dollar for the first time in terms of daily turnover in foreign exchange transactions. The HKMA also noted that trading between US dollar and Renminbi rose by 3.6 times to account for 17.7% of total average daily turnover, up from 4.5% in 2010, surpassing Hong Kong dollar against US dollar as the most heavily traded currency pair in the Hong Kong market. This indicates that the RMB is playing a more dominant role in trade and investment activities and that as far currency trading is concerned, Hong Kong has lived up to China’s expectations. Foreign exchange trades involving offshore Renminbi (CNH) were around 63% of all Renminbi trades. Even though the Dim Sum bond market has not developed as expected, Hong Kong as an offshore center for the RMB has.

4.0 Hong Kong’s role in the development of the RMB bond market

Hong Kong’s privileged position with China is consolidated through seven different Close Economic Partnership Arrangements (CEPAs), which allow banks in Hong Kong to open branches in China with less capital and within a shorter time frame. Given the fact that Hong Kong has one of the highest concentration of large banking institutions in the world (Garcia-Herrero, 2011), it is reasonable to expect that more banks will move into Hong Kong in order to have easier access to Mainland China in the future. As a matter of policy, China will first promote polices which will allow the RMB to be first regionalized before it can be truly internationalized. Hong Kong will play a pivotal role in the regionalization process and there is much to be gained in being in Hong Kong before investing opportunities are opened up in the Mainland.

The Dim Sum bond market has been compared with the Japanese Euro Yen bond market that evolved to allow foreigners to finance Japan’s corporate growth in the 1980s amidst rising pressures on Japan to revalue its currency (Koo, 2003). China today is in a similar state Japan was in the 1980s. Foreigners would like to invest in China’s growth but China would like to maintain strict administrative

\(^{9}\) Triennial Central Bank Survey of Foreign Exchange and OTC Derivatives Markets Activity, BIS Reports. 2013.
controls over the direction of that growth. There are mounting pressures on China to revalue the RMB and internationalize its currency and permit free movement of capital across its borders. But, China lacks the financial sophistication that will permit it to open up its capital account without concurrent concerns about what free convertibility might entail. It is useful to recall that Japan delayed the opening of its markets fearing that hot money would flow in and exacerbate the problem of a rising yen. But when the markets were effectively opened up, capital actually flowed out of Japan on a net basis. Japan lacked suitable investment options at home and residents were keen to invest overseas. Such an outcome for China would have serious implications for its banking system that fuels the state controlled domestic sector. China is determined not to open up its domestic markets too soon and markets in Hong Kong will be relied upon to moderate the flow of offshore yuan into the Mainland.

Of course, allowing multinational financial institutions and corporations to issue onshore in Shanghai would be viewed more favorably than allowing such entities to issue in Hong Kong. It is not that bond markets in Mainland China lack the desirable characteristics which Hong Kong is perceived to have. In fact, the bond market in Hong Kong, contrary to general beliefs, is presently not so active a market that it would be expected to stimulate the demand for Dim Sum bonds by virtue of its own inherent momentum. Not only is the market small compared to that of Mainland China’s, the need for long term financing in Hong Kong barely goes beyond five years (Latter 2008). The residents of Hong Kong have a distinct, dichotomous preference function: they prefer either the banking market or the stock market. The majority of the demand for long term bonds comes from property developers, whose projects are usually completed within the five year time frame. Overall interest in bonds in Hong Kong, both from issuers and investors, is moderate at best (Latter 2008). Multinational corporations and financial institutions will prefer to have the privilege of issuing securities in the Mainland rather than in Hong Kong and there indeed might be a demand for such securities in the Mainland. The Chinese authorities understand this motivation all too well and yet they continue to liberalize gradually the markets in Hong Kong and delay the opening the markets in the Mainland to foreign competition.
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The internationalization of a currency is a gradual process and a currency is internationalized only after it has been regionalized to a certain degree. In that respect, the structure and dynamics of the Dim Sum bond market will be carefully watched by global investors and the ultimate test of its success will be determined by the market’s ability to attract foreign investors and issuers alike. If foreign financial institutions and banks were keen on positioning themselves in Hong Kong in anticipation of China opening up its channels of repatriation of offshore RMBs through Hong Kong, we would expect an increase in the number of authorized institutions in Hong Kong since the Dim Sum bond was initiated in 2007. This has not occurred. In fact, the number of authorized institutions has remained stable around 200 since 2007. The reason might be that foreign institutions actually prefer to access the Chinese market directly as shown by the rapid growth of foreign financial institutions in Shanghai (Garcia-Herrero, 2011). Chinese authorities may have already apprehended this unexpected course of events.10

China has initiated offshore centers in Taiwan (2012), London (2012) and Singapore (2013) and has indicated that it would expand the scope of the offshore center in London soon. Such enhancements will not only provide alternative venues to Hong Kong but also reduce the pressures on itself to open up Shanghai to foreign currency and offshore RMB inflows soon. If the RMB is to become an international currency in the future, Hong Kong will assuredly play an important role but it might not be the dominant one.

Hong Kong specializes in institutional banking relationships whereas Singapore emphasizes corporate banking relationships (Garcia-Herrero, 2011). The Dim Sum bond market will get the needed boost when corporations begin to issue bonds in this market on a larger scale. In May 2013, both London and Singapore recorded their first RMB denominated bond sales whereas Taiwan sold its first RMB bond in February 2013. London and Singapore’s superior corporate linkages could lead to bigger RMB bond markets in their respective regions. Corporate issuers might prefer to issue in London and Singapore

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10 On September 29, 2013, Shanghai was designated as a free trading zone. However, specifics about policy changes have not been announced as of November.
than in Hong Kong. The London market will carry the RMB bond market beyond the Asian time zone and this can only add to the global liquidity of RMB bond markets. Also, Taiwan’s trade with Mainland China has greater promise than Hong Kong’s. Therefore, Singapore and Taiwan will compete with Hong Kong to divert offshore balances to their respective hubs and it is evident that both nations have scalable advantages over Hong Kong. Hong Kong will face formidable challenges in the years ahead.

5.0 Conclusion

We review the origins of the Dim Sum bond market in Hong Kong and analyze its growth since its inception in 2007. Even though the market was not initiated to absorb the increased levels of offshore RMBs circulating on account of China’s policies to foster trade settlements in RMBs, trade liberalization policies enacted by China in 2010 did in fact lead to a fourfold increase in the size of the RMB bond market in 2011. The trend continues even today and the RMB bond market is expected to surpass the critical size of $25 billion in 2013. This, according to the conventional wisdom about emerging bond markets, is likely to encourage foreign institutions to issue in the Dim Sum bond market in the near future.

Hong Kong has played a pivotal role in promoting the Dim Sum bond market. But China’s recent moves to begin offshore centers in Taiwan, Singapore and London and the issuances of RMB denominated bonds in each of these three regions in 2013 point to a motive to diversify the strategy with regard to promoting the RMB as an international currency. Hong Kong no longer enjoys the unique status of being the only place where RMB bonds are issued. In the ultimate analysis, the offshore market in Hong Kong will be integrated with the Mainland markets; the markets in Taiwan, Singapore and London will not be. Thus, there are natural limits to the extent Hong Kong can grow as an independent offshore center for Dim Sum bonds and eventually the Chinese yuan.
The Dim Sum Bond Market in Hong Kong

References


CNY supports CNY reserve-ification, Special report, Standard Chartered Bank, January 2011.


## Table 1

### Important Financial Indicators in 2007 and 2013 in Comparison to the RMB Deposits and Bond Issuance in Hong Kong

<table>
<thead>
<tr>
<th></th>
<th>Unit</th>
<th>2007</th>
<th>2013</th>
<th>%age Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Currency Demand Deposits in HK</td>
<td>U.S. $ Million</td>
<td>20,816</td>
<td>60,532 (2)</td>
<td>190.8</td>
</tr>
<tr>
<td>Foreign Currency Savings Deposits in HK</td>
<td>U.S. $ Million</td>
<td>66,604</td>
<td>182,952 (2)</td>
<td>174.7</td>
</tr>
<tr>
<td>Foreign Currency Time Deposits in HK</td>
<td>U.S. $ Million</td>
<td>269,253</td>
<td>307,962 (2)</td>
<td>14.37</td>
</tr>
<tr>
<td>Local Currency Bonds China</td>
<td>U.S. $ Million</td>
<td>1,688,000</td>
<td>4,044,744 (2)</td>
<td>136.5</td>
</tr>
<tr>
<td>Local Currency Bonds Hong Kong</td>
<td>U.S. $ Million</td>
<td>97,980</td>
<td>177,490 (2)</td>
<td>81.1</td>
</tr>
<tr>
<td>Foreign Currency Bonds China</td>
<td>U.S. $ Million</td>
<td>34,970</td>
<td>159,520 (2)</td>
<td>356.2</td>
</tr>
<tr>
<td>Foreign Currency Bonds Hong Kong</td>
<td>U.S. $ Million</td>
<td>44,550</td>
<td>129,020 (2)</td>
<td>189.6</td>
</tr>
<tr>
<td>Total Remittance of the Renminbi Cross</td>
<td>U.S. $ Million</td>
<td>4,508 (1)</td>
<td>43,750 (2)</td>
<td>870.5</td>
</tr>
<tr>
<td>Border Trade Settlement (Hong Kong)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of Authorized Banking Institutions in Hong Kong</td>
<td>Unit</td>
<td>200</td>
<td>201</td>
<td></td>
</tr>
<tr>
<td>Number of Institutions Doing Business in RMB in Hong Kong</td>
<td>Unit</td>
<td>37</td>
<td>140</td>
<td></td>
</tr>
<tr>
<td>Total RMB Deposits in Hong Kong</td>
<td>U.S. $ Million</td>
<td>4,531</td>
<td>112,756</td>
<td>2388.5</td>
</tr>
<tr>
<td>RMB Bonds Issued in Hong Kong</td>
<td>U.S. $ Million</td>
<td>1,340</td>
<td>18,480 (3)</td>
<td>1279.1</td>
</tr>
</tbody>
</table>

(1) As of September 2010  
(2) As of June 2013  
(3) As of August 2013
## Appendix A

### Chronology of Policy Measures Enacted to Develop the Dim Sum Bond Market

<table>
<thead>
<tr>
<th>Date</th>
<th>Introduction of/Changes in Policy Measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 2004</td>
<td>Ban against Hong Kong banks accepting yuan deposits (including money exchanges and remittances) is lifted.</td>
</tr>
<tr>
<td>January 11, 2007</td>
<td>Restrictions on the issuance of yuan-denominated bonds by the Chinese subsidiaries of foreign banks in Hong Kong were formally lifted. The People's Bank of China (PBoC), China's central bank, announced that mainland financial institutions can issue Renminbi (RMB) financial bonds in Hong Kong with clearance from the central bank.</td>
</tr>
<tr>
<td>June 26, 2007</td>
<td>China Development Bank issued the first yuan currency bond outside Mainland.</td>
</tr>
<tr>
<td>August 9, 2007</td>
<td>The active phase of the global financial crisis, which manifested as a liquidity crisis, began on this date when BNP Paribas terminated withdrawals from three hedge funds citing &quot;a complete evaporation of liquidity&quot;</td>
</tr>
<tr>
<td>November 9, 2008</td>
<td>China announced 4 trillion RMB fiscal ($586 Billion) stimulus package</td>
</tr>
<tr>
<td>December, 2008</td>
<td>Eligible Mainland and Hong Kong enterprises to use Renminbi to settle trade transactions</td>
</tr>
<tr>
<td>December 8, 2008</td>
<td>Restrictions on the issuance of yuan-denominated bonds by the Chinese subsidiaries of foreign banks in Mainland China was formally lifted by the State Council</td>
</tr>
<tr>
<td>April 8, 2009</td>
<td>State Council decided to introduce a pilot scheme for using Renminbi in cross border trade settlements and allowed Hong Kong banks to issue RMB bonds</td>
</tr>
<tr>
<td>May 8, 2009</td>
<td>Shanghai City government confirmed the lifting of the restrictions on the issuance of yuan-denominated bonds by the Chinese subsidiaries of foreign banks in mainland China</td>
</tr>
<tr>
<td>June, 2009</td>
<td>Scope of trade settlements in RMB greatly enhanced. China’s State Council decided to use RMB in cross-border trade settlement as part of its long-term plan to globalize its currency and reduce the domination of the US dollar. The scheme only applies to dealings with 450 designated Chinese enterprises in five cities — Shanghai, Shenzhen, Guangzhou, Dongguan and Zhuhai. Outside the mainland, it is open only to 10 ASEAN nations, Hong Kong and Macau. The scheme is expected to cover more areas and countries when it wins widespread appeal.</td>
</tr>
<tr>
<td>July 6, 2009</td>
<td>China and Hong Kong begin yuan-denominated trade settlement.</td>
</tr>
<tr>
<td>February, 2010</td>
<td>HKMA streamlines operational arrangements of offshore RMB business in Hong Kong</td>
</tr>
<tr>
<td>June 22, 2010</td>
<td>China authorities announced a major expansion of the RMB trade settlement scheme with the rest of the world</td>
</tr>
<tr>
<td>July, 2010</td>
<td>Offshore RMB trading begin in Hong Kong</td>
</tr>
<tr>
<td>July 19, 2010</td>
<td>Regulatory Changes that freed the yuan to be used for private investment setting off the issuance of bonds in Hong Kong. China expanded the trade settlement program that lets Chinese companies pay for imports with yuan instead of dollars. As a result foreign companies are building up yuan deposits. Only a limited amount of yuan can be brought from Hong Kong to China and vice versa without permission.</td>
</tr>
<tr>
<td>July 19, 2010</td>
<td>Clearing Agreement on RMB business amended; restrictions on account opening of corporate and interbank transfers removed. RMBs in Hong Kong can move around freely. Several financial products denominated in RMBs initiated in Hong</td>
</tr>
<tr>
<td>Date</td>
<td>Event Description</td>
</tr>
<tr>
<td>--------------------</td>
<td>-------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>August 17, 2010</td>
<td>China authorities launched a pilot scheme for eligible institutions outside the Mainland to invest in the Mainland’s interbank bond market</td>
</tr>
<tr>
<td>September, 2010</td>
<td>China issued its first yuan denominated bond issue in Hong Kong</td>
</tr>
<tr>
<td>December 6, 2010</td>
<td>The number of approved Mainland Designated Enterprises (MDE) – companies which can settle both exports and imports in RMB – was expanded to 67,359 from 365. A non-MDE can only settle imports in RMB.</td>
</tr>
<tr>
<td>December, 2010</td>
<td>Measures introduced to refine Hong Kong’s offshore RMB business</td>
</tr>
<tr>
<td>January 13, 2011</td>
<td>Domestic companies can move Renminbi offshore for investment purposes. Chinese companies can use yuan to buy foreign assets</td>
</tr>
<tr>
<td>January 13, 2011</td>
<td>Shanghai will make it easier for foreigners to invest in the private equity sector</td>
</tr>
<tr>
<td>January 13, 2011</td>
<td>Overseas sovereign wealth funds, pension funds, insurance companies and funds of funds will be able to directly invest in Chinese companies</td>
</tr>
<tr>
<td>January, 2011</td>
<td>Pilot scheme for settlement of Mainland’s overseas direct investment in Renminbi launched. Chinese companies can now take funds out of China for M&amp;A.</td>
</tr>
<tr>
<td>August 17, 2011</td>
<td>China endorsed the long-awaited mini-QFII and indicated that an initial quota of $3.1 billion would be shared among Hong Kong subsidiaries of Chinese securities companies and fund houses to allow them to invest directly into the mainland's securities market. Chinese firms will also be allowed to buy into an ETF linked to Hong Kong stocks. Mainland Chinese companies were given the official go-ahead with regard to issuing offshore Renminbi bonds in Hong Kong. Earlier, only mainland financial institutions and overseas companies were able to issue</td>
</tr>
<tr>
<td>October 13, 2011</td>
<td>China finalized and published its rules allowing RMB FDI effective October 13, expanding on its policies for U.S. dollar FDI flows already in place. Any application for RMB FDI valued at or above RMB 300 million ($47 million) must be submitted to the Ministry of Commerce for prior approval. Amounts below RMB 300 million need not be. FDI investments in securities and derivatives investments are still prohibited but foreign investors are allowed to participate in private placements of publicly listed companies subject to approval by the Ministry of Commerce. RMB funds for M&amp;A activities will have to be approved by the Ministry of Commerce. These actions open up new channels of flow for offshore RMB into onshore in many ways and bode well for the offshore RMB market.</td>
</tr>
<tr>
<td>June 14, 2012</td>
<td>The Hong Kong Monetary Authority (HKMA) announced a facility for providing Renminbi (RMB) liquidity to Authorized Institutions participating in RMB business (Participating AIs) in Hong Kong. The facility will make use of the currency swap arrangement between the People’s Bank of China and the HKMA. With effect from 15 June 2012, the HKMA will, in response to requests from individual Participating AIs, provide RMB term funds to the Participating AIs against eligible collateral acceptable to the HKMA. The introduction of the facility is to support the continuous deepening of the RMB capital market in Hong Kong and to reinforce Hong Kong’s role as the global hub for offshore RMB business.</td>
</tr>
<tr>
<td>October 11, 2012</td>
<td>PBoC announced that a RMB clearing bank will be set up in Taiwan. This will consolidate Taiwan’s position to be the second key offshore RMB center behind Hong Kong but ahead of London and Singapore. Bank of China (Hong King) became Hong Kong’s RMB clearing bank in 2003. It could lead to the second offshore Chinese currency CNT – as opposed to CNH in Hong Kong.</td>
</tr>
<tr>
<td>January 28, 2013</td>
<td>The Central bank of Taiwan (CBC) approved Bank of China (Taipei) as the</td>
</tr>
</tbody>
</table>

23
<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 30, 2013</td>
<td>13 companies and 6 banks are allowed to participate in China’s groundbreaking cash management pilots designed to better funnel Renminbi and foreign currencies across the border.</td>
</tr>
<tr>
<td>January 30, 2013</td>
<td>PBoC appointed ICBC (Singapore) to be the RMB clearing bank in Singapore</td>
</tr>
<tr>
<td>January 30, 2013</td>
<td>PBoC doubled Singapore’s swap line from 150 million RMB to 300 million RMB</td>
</tr>
<tr>
<td>February 6, 2013</td>
<td>China continues to award QFII quotas more swiftly. The State Administration of Foreign Exchange (SAFE) granted Abu Dhabi Investment Authority $500 million and Kuwait Investment Authority $700 million in additional quota, taking both to $1 billion each. They join five others (all State backed) which have $1 billion quota as well: Government of Singapore Investment Corporation, Hong Kong Monetary Authority, Norway’s Norges Bank, Qatar Investment Authority and Singapore’s Temasek Fullerton Alpha Investments.</td>
</tr>
<tr>
<td>June 4, 2013</td>
<td>The Singapore Branch of the Industrial and Commercial Bank of China (ICBC) kicked off its RMB clearing service in Singapore, marking an important step in Singapore’s development as an offshore RMB center. ICBC’s Singapore branch is the first RMB clearing bank designated by China in another country; with Hong Kong and Taiwan previously the only places outside of Mainland China with designated RMB clearing banks.</td>
</tr>
<tr>
<td>June 22, 2013</td>
<td>Bank of England and the Peoples Bank of China signed a 3-year 20 billion yuan ($32.6 billion) swap deal</td>
</tr>
<tr>
<td>July 15, 2013</td>
<td>Renminbi Qualified Foreign Institutional Investor (RQFII) program extended to include institutions in Singapore and London. The program was extended to Taiwan in June and to Hong Kong in March. Total quota raised from $80 billion to $150 billion in an effort to increase foreign investment into the mainland.</td>
</tr>
<tr>
<td>July 15, 2013</td>
<td>PBoC lifts a host of restrictions designed to make RMB cross border trade settlement easier to conduct and make inter and intra company loans denominated in RMB. RMB trade settlement to China’s total trade increased from 3% in 2010 to 9% in 2011 and 12% in 2012.</td>
</tr>
<tr>
<td>July 25, 2013</td>
<td>The use of RMB in international payments hit a record market share of 0.87% in June, growing threefold from 0.24% two years ago. The RMB now ranks 11th in the rankings of world payments currencies.</td>
</tr>
<tr>
<td>August 31, 2013</td>
<td>In 2012, China’s total trade amounted to $3867 billion, surpassing the US by a billion US dollars</td>
</tr>
</tbody>
</table>

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