The great contender

AS CHINA ASSUMES THE POSITION OF NUMBER TWO GLOBAL ECONOMIC POWER, MORE MULTINATIONALS ARE LOOKING TO TRADE IN ITS CURRENCY, AS **GRAHAM BUCK** REPORTS.

This has been the year when the strength of China's growth has seen it displace Japan as the world's second-biggest economy. Last month David Cameron led the UK's largest-ever trade delegation to the country, with more than 40 top business leaders in the entourage, in a bid to strengthen commercial ties and to double bilateral trade between Britain and China over the next five years to £60bn. Cameron arrived only days after French president Nicolas Sarkozy courted China's leader Hu Jintao on a state visit to France, and other EU countries have also been working hard to boost their trade with China.

Recent months have seen the Chinese government's previously low-key campaign to encourage international use of its currency, the renminbi, stepped up a couple of gears. Over the summer Beijing took a series of measures to strengthen the renminbi's credentials as an international reserve currency. Many predict that, in time, this role will lead to it seriously challenging the dollar's dominance of the global monetary system.

In June, China announced that it would once again allow the renminbi to float more freely against the US currency. The move followed a similar experiment introduced in 2005, but ended three years later when a peg between the two currencies was reimposed in mid-2008 as the international financial crisis deepened. Resumption of the float was accompanied by an extension of the programme that permits Chinese companies to use the renminbi in settling cross-border trades.

These move were followed in July by Chinese regulators lifting a series of restrictions that had blocked the free flow of the Chinese currency in Hong Kong. The former British crown colony appears set to become a leading offshore centre for trading in the renminbi. Any company may now open a renminbi bank account in Hong Kong. It was a development that local banks took advantage of by promptly launching a range of renminbi-denominated products. In addition, limitations were abolished on the types of company able to access renminbi loans. Foreign companies now have new ways in which to hold and invest renminbi received through their trading with China.

Further liberalisation followed in August. The country's central bank, the People's Bank of China (PBOC), announced that a pilot project would be launched to permit foreign central banks and lenders from overseas to step up their investment in China's domestic interbank bond market. The project would "encourage cross-border renminbi trade settlement" and "broaden investment channels for renminbi to flow back [to China]".

Beijing has steadily relaxed its control of the renminbi in Hong Kong, but it has not relinquished it entirely. For the growth in the market to really accelerate, the remaining controls on cross-border renminbi flows need to be lifted, which could take several more years. In the meantime, major banks such as HSBC and Standard Chartered are strengthening their presence in the offshore renminbi market in anticipation of further growth, and are actively encouraging corporate customers to use the currency instead of the dollar for trade deals with China. Incentives such as reduced transaction fees are being offered to attract business.

"The Chinese government, through the PBOC, has planned a gradual process, as the system couldn't cope with too sudden a change," says Chris Lewis, HSBC's head of trade and supply chain for Greater China (in this case, mainland China, Hong Kong, Macau and Taiwan). "It will be a while longer before the renminbi becomes fully convertible. Although some forecasters see it happening as early as 2012, others suggest it could take until the end of the decade. The first stage in the process is to promote cross-border trade in renminbi."

What is the background to these recent changes? Global trade over the past century has been transformed by ever more efficient technology, communications and transportation, together with unprecedented manufacturing and consumer demand, according to Neil Daswani, regional head of transaction banking for north-east Asia at Standard Chartered Bank. The rise of the US was a major factor in this process, as was the creation of post-war agencies such as the World Trade Organization, whose predecessor the General Agreement on Tariffs and Trade (GATT) resulted from the Bretton Woods Conference of 1944.

The Second World War ended with European economies in tatters, and the US dollar replaced the gold standard as the international reserve currency and became the trusted currency for international trade. Despite the collapse of the Bretton Woods system in the late 1960s, the dollar remained the established international trading currency in the absence of realistic alternatives. Even today, although the euro and sterling are commonly used for international trade, the dollar remains the trading currency of choice in much of the world, including trade with and amongst Asian countries.

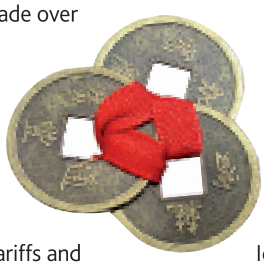
For China, as the world's second largest exporter and third largest importer, creating the optimum conditions for exporters and importers has become a major priority, says Daswani. However, the need to trade in dollars poses a major hindrance for both Chinese companies and their international trading partners, not least due to restrictions on the convertibility of the renminbi.

At the same time the Chinese government and central bank are keen to avoid deregulating the market to the extent that the currency becomes vulnerable to speculation. In 2008, aiming to balance these competing requirements, premier Wen Jiabao announced a pilot scheme to enable cross-border renminbi trade settlement to take place with approved entities in Hong Kong and Macau able to demonstrate genuine trade transactions with eligible enterprises. Five cities (Shanghai, Guangzhou, Shenzhen, Dongguan and Zhuhai) qualified for the scheme, known as Mainland Designated Enterprises (MDEs).

The scheme developed over the first half of 2009, with the initial guidelines and rules published in early July. Both HSBC and Standard Chartered competed to be the first international bank to conduct end-to-end two-way cross-border renminbi trade settlement transactions, within days of the PBOC Shanghai's publication of its initial draft of the operational guidelines for cross-border trade. HSBC claims victory, with its first transaction completed on 6 July 2009.

Both banks quickly followed this by completing cross-border renminbi trade settlement deals, acting as both a settlement bank and agent bank. Pilot schemes have since been expanded to include the Association of Southeast Asian Nations (ASEAN) countries of Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam. Renminbi trade can be two-way, conducted on open account or using documentary credits.

THE NEED TO TRADE IN DOLLARS POSES A MAJOR HINDRANCE FOR BOTH CHINESE COMPANIES AND THEIR INTERNATIONAL TRADING PARTNERS.



To open an account, companies must prove they have genuine trade transactions with MDEs, although the authorities have since broadened the scheme's scope, allowing exports to be paid in renminbi from non-MDEs.

Further initiatives can be expected to attract more companies to renminbi trading in the months ahead. At the end of September 2010, inter-dealer broker Icap launched renminbi trading against the dollar on its electronic foreign exchange platform EBS. All renminbi trades will settle in Hong Kong, and banks wishing to trade in the currency pair must have a clearing and settlement arrangement with a Hong Kong authorised institution. Icap has said that it plans to expand the facility to enable investors also to trade Hong Kong-settled renminbi against the euro, yen and the HK dollar.

What are the benefits of renminbi trade settlements? For corporates in China, they include eliminating FX risk, reduced transaction costs, receiving and providing transparent pricing, and alignment of their international and domestic activities that makes their cash management, technology and accounting all more efficient, says Daswani.

"Settling in renminbi avails more buyers for exporters to China, potentially increasing sales, and more vendors for importers from China," he adds. "Overseas businesses meanwhile can become more competitive to customers in China, particularly as any FX costs can be stripped out of pricing, and can seek better terms from Chinese suppliers.

"For those conducting two-way trade, transacting in renminbi creates a natural hedge, as well as reducing reliance on US dollars. Furthermore, we would expect offshore demand for renminbi to increase significantly as the currency becomes increasingly liberalised." He adds that alongside the cash and risk management benefits for both domestic and overseas firms, the cross-border renminbi trade settlement pilot scheme helps to improve the efficiency of the transaction process.

HSBC's Chris Lewis says that counterparties outside mainland China are often enjoying cost benefits too. "As well as the efficiencies of getting money faster, Chinese exporters may also offer them, say, a 10% discount for dealing in renminbi."

Before the scheme was introduced there were – and continue to be for those not yet authorised to trade within its terms – a variety of obstacles, with documentation often time-consuming to prepare, while verifying receipt typically takes several days and involves various regulatory bodies.

"By using renminbi cross-border trade settlement, existing processes can be streamlined, with no need to suspend funds in EFV [Export Funds (subject to) Verification]; the State Administration of Foreign Exchange (SAFE) requirement is that foreign currency proceeds resulting from export trade from China should be credited to a special EFV account for verification before being credited to the exporter's account," explains Daswani.

Standard Chartered announced a further landmark in August with the launch of a renminbi corporate bond in Hong Kong's debt capital market. Although at 200m yuan (£19m) the bond was no blockbuster, it marked the first such launch for a foreign multinational corporate. The chief executive of Standard Chartered Bank (Hong Kong) said the bank was "taking a proactive role in increasing utilisation of the renminbi as a regional currency for investment, trade and reserves".

Despite the recent pace of development, few UK companies engaged in significant levels of business with China appear to have taken up the new facilities. Grainne Kelly, assistant treasurer at B&Q's parent group Kingfisher, says that the retailer has used non-deliverable forwards (NDFs) in the past to net investment hedge a subsidiary, but that has been the extent of its offshore renminbi experience and it has yet to trade or settle in the currency onshore.

Renminbi or yuan?

China has one currency. Its official name is the renminbi, while the country's unit of account is yuan. The distinction is the same as that made in the UK between sterling (the name of the currency) and the pound (the unit of account, used for prices and values).

AS WELL AS GETTING MONEY FASTER, CHINESE EXPORTERS MAY ALSO OFFER, SAY, A 10% DISCOUNT FOR DEALING IN RENMINBI.

"We do watch for developments in this area, though," she adds.

HSBC reports that its latest global Trade Confidence Index shows exporters and importers in key markets expect further growth in trade volumes settled in renminbi as China's role in global trade continues to expand. The bank, which launched its own renminbi trade settlement scheme in July 2009, has since extended it to 31 countries.

HSBC's survey, on which the Trade Confidence Index is based, covers 5,100 exporters and importers in 17 markets globally. It finds that while the US dollar will remain the dominant trade settlement currency globally, 56% of exporters and importers in Hong Kong, 49% in Malaysia and 24% in mainland China expect to settle some trade transactions in renminbi over the next six months. Around a quarter of traders polled from southeast Asia combined expect to use renminbi as trade settlement currency over the same period, while nearly one in 10 traders in North America, the Middle East and Europe combined plan to settle future trade in renminbi.

The responses show that Greater China remains top trade partner for Hong Kong, Australia and Vietnam, while mainland China will look to southeast Asia for growth in the next six months. Globally, Greater China is identified among the top three markets, with strongest growth prospects over this period.

"As businesses globally continue to strengthen their trading links with China, they are at varying degrees preparing to use the renminbi as one of their trade settlement currencies in the near future," says Andrew Long, HSBC's head of global transaction banking. "In 10 years' time, China's exports are expected to reach \$2.4 trillion. It is critical for financial institutions to anticipate and keep pace with customer demand, which is slowly catching up with developments around renminbi internationalisation. To react quickly, financial institutions need either to build their own platform or choose a partner with the access, scale and capabilities for renminbi clearing and trade settlement."

Lewis adds that international banks such as HSBC can help with the education process, getting involved and assisting clients who export to and import from China. "Customers regularly ask us: 'If I'm sitting on renminbi, will it be difficult to covert it into another currency?' The answer is no it won't, although it can sometimes take a while. People want to be renminbi-enabled; my customers in Hong Kong are getting ready, as they will ultimately use the currency for the majority of their transactions. And while there is a particular concentration of interest in the Asia region, we are also seeing plenty of enquiries from companies in Europe, the US and Latin America."

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