Currency revolution

ADNAN AHMED EXAMINES THE FUNDAMENTAL CHARACTERISTICS, EVOLVING TRENDS AND FACTORS THAT CONTRIBUTE TO THE GROWING INTERNATIONAL IMPORTANCE OF THE RENMINBI.

China's remarkable economic boom is now in its fourth decade. Economic development fuelled by political and social reforms has made China the greatest beneficiary of globalisation. Manufacturing, the largest sector of China's economy, continues to benefit from domestic R&D activity. China's growing portfolio of international investments and a continuous stream of fiscal and monetary reforms have impacted China's domestic market as well as its exports (see Figure 1). The value of trade between China and the Arab states, for example, rose from $36.4bn in 2004 to $107.4bn in 2009, and now stands at $150bn.

KEY DRIVERS Given that China has a 10% share of global trade, it seems inevitable that the significance of the renminbi (RMB) will grow. China's share of global investments has also strategically positioned the country in the world's financial markets. These economic and financial trends negate the possibility of the renminbi remaining just another domestic currency.

The blocks are also falling into place because an internationalised renminbi represents the will and mood of the player – that is, China and its economic managers. There are clear signals that the intention is to expand on the strong foundation laid down over the past decade. Openness is appearing across the spectrum in mainland China – in the buying of corporate assets, personal overseas travelling/shopping, and other variables. China has transitioned from a parts supplier to a manufacturer and we are increasingly seeing Chinese local brands competing in the global arena.

China holds the largest US dollar reserves in the world – an estimated US$2 trillion (two-thirds of the estimated total FX reserves of US$3.2 trillion). The impact of the recent global financial downturn on major economies is pushing China towards quicker and concrete actions to decrease its reliance on other currencies, including the US dollar. This can be achieved only by pushing for wider and wider acceptance of the renminbi globally.

Hence, along with China's ambition to be a major global player, reducing the risks and costs of its vast export industry and diversifying its national balance sheet remain the key drivers for the internationalisation of the renminbi.

THREE-STAGE APPROACH This internationalisation is a three-stage process (see Figure 2), with cross-border trade being the foundation.

The first stage started in 2009 with a pilot across five Chinese cities involving a small group of exporters. The scope was expanded to 20 key cities and provinces in June 2010, and went nationwide in August 2011. The scheme allows all entities to settle trade transactions for imports to and exports from mainland China (see Box 1). Goods, services and other current account items are all covered, although there are some exceptions. One is that only mainland designated entities (MDEs) are allowed to receive payments for exports unless approved by the People's Bank of China (PBOC). It is important to note that overseas-to-overseas renminbi transactions are not regulated by the PBOC but may be subject to a country's local regulations.

Easing regulations to permit trade settlements is fundamental to internationalisation, but the availability of renminbi investment options (stage 2) is no less important for building up and sustaining volumes. If a company cannot hold, move or invest in a currency, it has little interest in receiving or making payments in that currency. Favourable regulations for investments in renminbi are therefore crucial. The new regulations easing overseas direct investment for mainland enterprises and foreign direct investment from offshore enterprises, economic organisations and individuals are steps in the right direction. With Hong Kong currently the epicentre of offshore investments, there is more work in progress from this perspective.

As China liberalises its monetary policy, there has been debate about whether and when the renminbi will become a major reserve currency (stage 3). China's economy is now the second largest in the world and is forecast to overtake the US economy by 2020 (assuming growth rates in both countries stay similar to current levels). If we go back a decade, the trade shares of both the US and the EU were more than four times that of China. In 2010, China was ahead of the EU and within a single percentage point of the US.

BENEFITS FOR CORPORATES The regulations and policy changes introduced by the PBOC have created significant value for corporates irrespective of whether they are in mainland China or not. Benefits range from tangible cost savings through eliminating unnecessary foreign exchange costs, faster payment cycles, natural hedging of expenses and unlocking trapped cash to intangibles such as stronger supplier relationships and a wider customer base. Let's look at the specific scenarios and benefits for each party involved.

BENEFITS FROM RENMINBI PAYMENTS ORIGINATING IN MAINLAND CHINA Universal permission (both MDEs and non-MDEs are allowed to pay in renminbi from China) and the inherent benefits for both importer and exporter have supported renminbi payments received by overseas companies from mainland companies to gain a major share among renminbi settlements. Importers reduce their exchange rate risk while overseas counterparties, expecting appreciation in renminbi against their local currencies, are willing to accept renminbi payments. Flexibility to convert renminbi received into the currency of the counterparty's choice through offshore markets and the ability to hold investments in renminbi also act as an incentive for overseas exporters to transact in renminbi. From the perspective of both importers and exporters, because the receivable and payable or investment currency is the same, the transaction saves unnecessary foreign exchange costs at one or both ends.

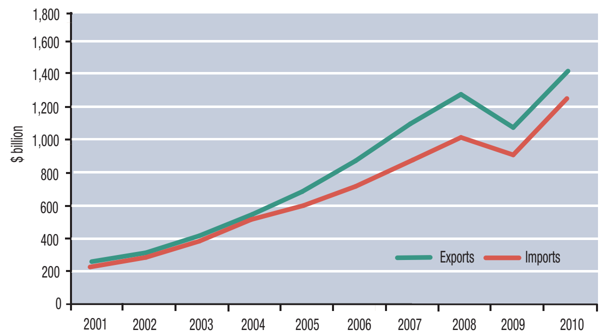
In a local survey, one-third of HSBC clients in China taking part in renminbi transactions said they had switched to pay in renminbi for imports after their foreign counterparty requested it.

BENEFITS FROM RENMINBI PAYMENTS TERMINATING IN MAINLAND CHINA In China, the leading concern for traders surveyed in HSBC's Trade Confidence Index is fluctuating exchange rates. Hence, renminbi-based payments provide Chinese exporters with a natural hedge for having their receivables and expenses in one currency. In addition, they benefit from simpler administrative processes for tax rebates. From the overseas importer's perspective, renminbi settlement eliminates multiple FX costs and can potentially result in shorter payment cycles. As renminbi settlement eliminates suppliers' concerns about exchange rate fluctuation, it is estimated that overseas importers can negotiate a 5–7% currency fluctuation premium in renminbi quotation. Distribution of these gains is a matter of negotiation between the parties involved.

INITIAL AND FORESEEABLE SUCCESS Figure 3 shows the growing influence of the renminbi. Other standout facts include the following:

- In 2010, out of RMB20 trillion only RMB506bn was settled in renminbi. In the first half of 2011, RMB950bn worth of trade was settled in renminbi.

Figure 1: China's trade with the world 2001–2010



Calculated by USCBC. PRC exports reported on a free-on-board basis; imports on a cost, insurance and freight basis
Source: PRC National Bureau of Statistics

Figure 2: RMB internationalisation: a three-step process

1 A GLOBAL TRADE CURRENCY

Trade settlement in RMB generates multicurrency liquidity pools

- **June 2009** Pilot launch of cross-border RMB trade settlement scheme
- **June 2010** Expansion of cross-border RMB trade settlement scheme
- **August 2011** Scheme expanded nationwide

2 A GLOBAL INVESTMENT CURRENCY

Multiple savings and investment options make RMB more attractive

- **2007** Mainland financial institutions issue RMB dim sum bonds in Hong Kong
- **August 2010** Onshore RMB interbank bond market opened to selected offshore RMB financial institutions
- **January 2011** Mainland enterprises can make overseas investments in RMB
- **August 2011** Hong Kong enterprises can invest in mainland securities under the RMB Qualified Foreign Institutional Investors (RQFII) channel. Mainland companies can issue RMB bonds in Hong Kong. Mainland investors can buy exchange-traded funds linked to Hong Kong stocks.
- **October 2011** Formalisation of RMB foreign direct investment

3 A GLOBAL RESERVE CURRENCY

Reserve usage signals arrival of RMB as a world currency

- **September 2011** Nigeria announces that 10% of its foreign reserves will be in RMB. Chile reports that 0.3% of its reserves are in RMB. Emerging markets such as Thailand, Brazil and Venezuela show interest in RMB.
- **2020** RMB accepted across the world as an international currency, paving the way for full convertibility and reserve currency status?

Box 1: Trade payments

PAYMENTS INTO MAINLAND CHINA

- Allowed for: goods exported by MDEs; services exported by MDEs and non-MDEs; intercompany loans; foreign direct investment; and additional capital infusions.
- Not allowed for: goods exported by non-MDEs (unless approved by PBOC); and expatriate salaries.

PAYMENTS FROM MAINLAND CHINA

- Allowed for: goods and services imported by MDEs and non-MDEs; intercompany loans (as approved by PBOC/SAFE on a case-by-case basis); overseas direct investment; dividend payments/repatriation of profit; and expatriate salaries.

- China's trade settled via Hong Kong in 2011 tripled compared with 2010, and renminbi deposits more than doubled compared with the beginning of 2011.
- Nearly eight out of 10 businesses in mainland China that have not yet started to use renminbi to settle cross-border trade are planning to use or adopt it conditionally in future transactions.
- Overall, traders indicated that the renminbi would become one of their top three most used trade settlement currencies.
- In 2011, renminbi ranked as the third most likely primary currency for trade settlement globally, maintaining the currency's position over sterling for the second year running.
- Renminbi ranks as the second most likely primary currency for trade settlement in Asia Pacific, after the US dollar.
- As the world prepares to increase trade with Greater China, the use of the renminbi to settle trade in the next six months is gaining momentum, led by traders in Greater China (48%), south-east Asia (12%) and the Middle East/North Africa (9%)
- In November 2011, the renminbi kicked off trading against the Australian dollar and the Canadian dollar in its onshore market. The latter have become the latest additions to seven other foreign currencies currently traded directly against the renminbi.

CHALLENGES AND WAY FORWARD We are still at an early stage and clearer trends are yet to emerge. The PBOC is picking up the pace of renminbi internationalisation. Nearly every month in 2011 saw a new development in the internationalisation of the renminbi.

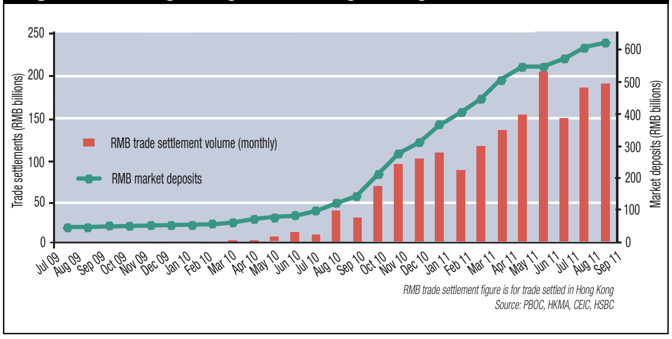
There are still challenges to be overcome even for the successful implementation of stage 1. The need to apply for MDE status for receiving payments in renminbi undoubtedly hampers the growth of renminbi payments to China. Although the number of MDEs rose from 300 in 2009 to over 67,000 in 2011, further growth or removal of this requirement will help stimulate inward renminbi payments.

Another factor that has restricted the growth of renminbi-based trade settlements is the awareness and readiness of corporates and other stakeholders to handle renminbi-denominated transactions. The offshore market, the dual exchange rate phenomenon, language barriers and the lack of understanding of rapidly changing PBOC regulations have all crowded the canvas for overseas bankers and corporates alike.

Since December 2011, HSBC has been offering a wide array of renminbi-based products and services in more than 50 countries. In the Middle East, HSBC launched its renminbi proposition for corporate customers in the UAE in July 2011. In December 2011, SABB (Saudi Arabia British Bank), a HSBC affiliate in Saudi Arabia, also launched a renminbi proposition.

The PBOC's goal is clear, and the central bank realises the risks along the way. On the one hand it is working towards the internationalisation of the currency; on the other hand it is conscious of the challenges these policy reforms will bring. History furnishes plenty of lessons here, Japan's Plaza Accord and its subsequent results being particularly notable.

Figure 3: Hong Kong – RMB's growing influence



RMB trade settlement figure is for trade settled in Hong Kong
Source: PBOC, HKMA, CEIC, HSBC

Box 2: CNH vs CNY

Unlike other openly traded currencies, the renminbi embraces complex trading and multiple exchange rates and markets.

There are two markets for renminbi – onshore mainland China and offshore in Hong Kong – yet the official SWIFT code is CNY for both. All payments, confirmations and documentation must show CNY as the currency code. There will be no relaxation in either SWIFT or the PBOC stance for a new currency code for the offshore market (CNH has been proposed).

The market rates for offshore deliverable renminbi are different to those in the onshore market. As such, this needs to be recorded as a different position and managed as a separate currency in a bank's risk and P&L systems in order for reporting to be correct.

Box 3: Renminbi vs yuan

China's first official regional paper-printed money dates back to 1024. The word "renminbi" ("people's currency") was first recorded in June 1949 and is the official currency of the People's Republic of China (PRC). The distinction between the renminbi (RMB) and the yuan is similar to that between sterling and the pound: renminbi refers to the Chinese money system, whereas a yuan is one base currency unit of renminbi. Yuan is used to denominate bills, and is the unit in which prices are measured.

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