A YEARNING FOR ¥UAN

It's London's dream to become the Western hub for offshore renminbi trading. So what will this mean for treasurers? asks Sally Percy

Let's take a moment to imagine China in 20 years' time. It is the powerhouse of the world, with an economy that is twice as large as the US economy, and it accounts for 24% of global output, up from 9% today.

It has a commercial banking system with interest rates set by market forces and a robust legal and supervisory infrastructure to underpin financial stability. Equal opportunities and social security are available to all. It has a strong fiscal system with properly financed local governments, world-class universities and resource-efficient industries. It is an active participant in world affairs.

Today, these are merely predictions made in reports by Standard Chartered and the World Bank, but they paint a good picture of what China could become if it can jump the hurdles it faces and grow as successfully in the next two decades as it has in the past three.

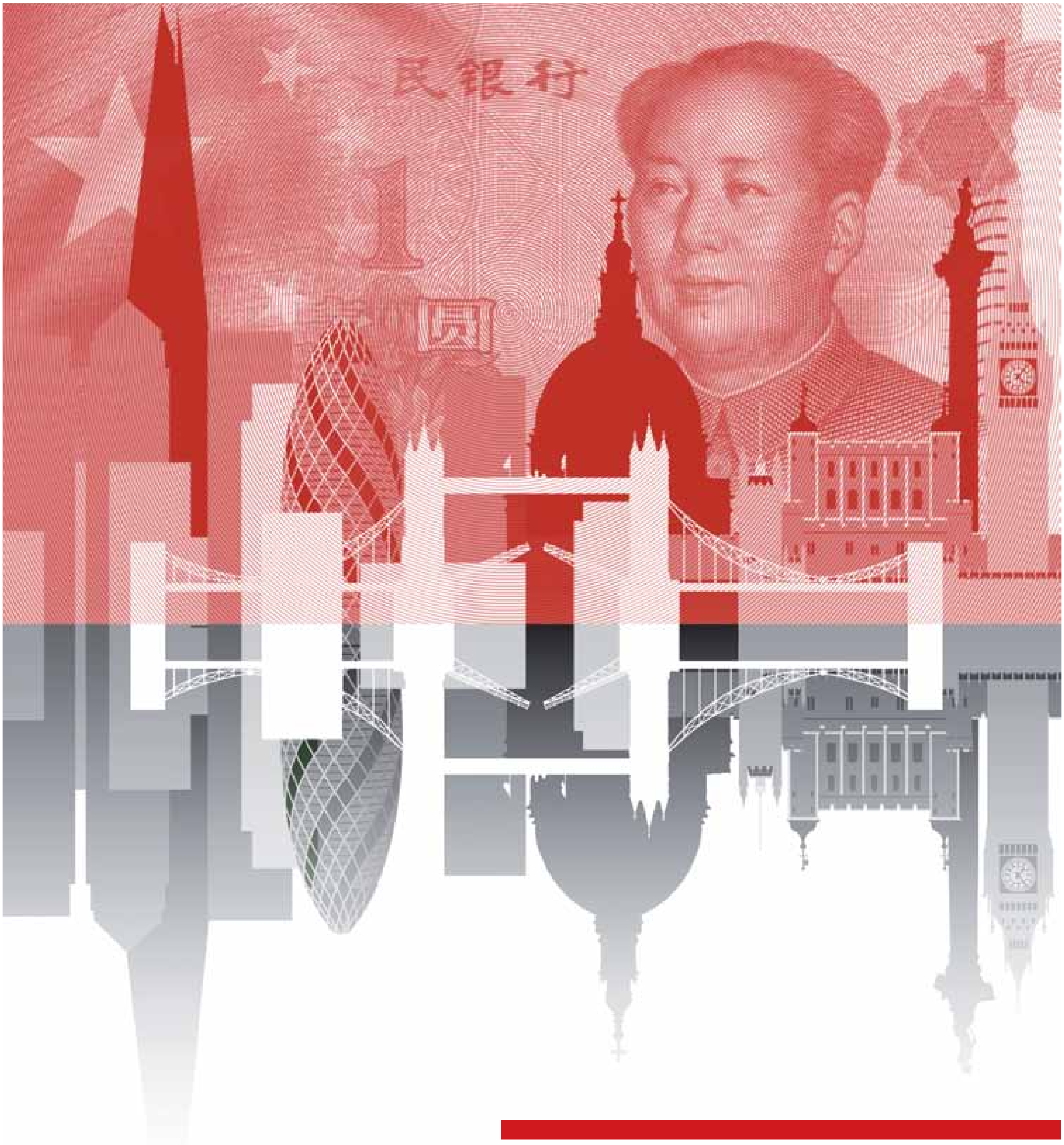
Internationalisation of the Chinese currency, the renminbi, is one of the most important hurdles that China must jump to achieve its full economic and political potential. At present, the renminbi is issued and controlled solely by the People's Bank of China (PBOC), which also decides exchange rates, while the State Administration of Exchange Control manages FX. The renminbi is pegged to the US dollar and China has maintained its competitiveness in the past by ensuring that its currency does not appreciate too quickly against the greenback. But, recently, the government has started to loosen its grip. In April 2012, the PBOC increased the currency's trading band from a daily rate of 0.5% to 1%, allowing market forces to play a greater role in determining the renminbi's value against the dollar.

"The general view is that the renminbi is no longer artificially valued," says Mark Boleat, policy chairman at the City of London Corporation. "It's not as it was a few years ago, when it was generally accepted that it was at an artificially low level." And Chinese authorities have begun to encourage the use of renminbi outside mainland China, with a view to it eventually becoming a fully convertible global currency.

Trade is the single most important driver behind China's quest for internationalisation. At present, it's hard for China to invoice for trade in its own currency, which acts as a curb on its growth. "Opening up renminbi is mostly about trade," says Philippe Lintern, head of global markets, Europe, at Standard Chartered. "If international companies can finance, settle and convert freely in yuan, business becomes much easier. And if doing business with China is easier and more cost-effective to do, then there will be more trade."

Other factors have a bearing on China's strategy of renminbi internationalisation. It holds more than $3 trillion in US dollar reserves, but these have gone down in value following the quantitative easing programme in the US and it wants to lessen its reliance on the dollar. An internationalised currency would also open the door to more investment in Chinese equities from abroad, encouraging stock exchanges in China to rise. And finally, there is the issue of political status. Powerful economies do not normally have controlled currencies.

Hong Kong has been the main beneficiary of more relaxed controls



RENMINBI: LONDON'S FOR THE TAKING?

London may see itself as the natural choice as a Western hub for offshore renminbi trading, but that doesn't mean other financial centres won't get a look-in. Frankfurt and Paris will be in the frame, as will New York and the Asian financial centres. Luxembourg, with its background as a wealth management centre, has even been touted as an option. "There will be some renminbi trading in all financial centres, including Hong Kong, Dubai, Singapore and New York," says Boleat. "All the financial centres work with each other, feed off each other and compete with each other."

VITAL STATISTICS

10%
China's average annual growth over the past three decades

500m
the number of Chinese people lifted out of poverty since 1982

$3.3tr
China's US dollar reserves at the end of March 2012

15%
the volume of China trade that will be denominated in RMB by 2015

13
the number of Chinese cities with a population of more than 10m by 2020

90.7bn yuan
foreign direct investment in China by the end of 2011

19%
China's predicted share of global GDP by 2015

over renminbi over the past seven years and it has already established itself as the major offshore centre for renminbi trading. This is down to its location, strong trading relationship with mainland China and the fact it has been designated as the official offshore clearing centre for renminbi by the Chinese authorities. By the end of December 2011, Hong Kong had 589bn yuan in customer deposits, according to a report prepared for the City of London Corporation by Bourse Consult. "Hong Kong is very established," says Paul Gooding, head of European RMB business development at HSBC. "It is the main offshore centre and I think it will stay that way."

Nevertheless, the Chinese realise that the internationalisation of renminbi cannot end with Hong Kong; for it to be widely accepted as a convertible currency, it also has to be traded in a major Western hub. Step forward London, which sees itself as the natural choice to complement Hong Kong, a view that the Chinese authorities seem to share. Not only is London the world's finance capital and the leading global centre for FX and metals trading, it also benefits from a significant time zone advantage, as its working day overlaps with those in Asia, Europe, the Middle East and the US. It has established legal and regulatory systems, experience of developing the eurodollar market in the 1970s and a cohort of major banking institutions based in the city, which can inject liquidity into the markets and offer a pool of skilled financial talent. It also has powerful government backing. In April, UK chancellor George Osborne launched the City of London initiative on London as a centre for renminbi business, a project that involves a number of top banks working together with support from the City of London Corporation.

The initiative aims to boost the London renminbi market, rather than launch it, because the city is already an established offshore centre for the Chinese currency. According to Bourse Consult's research, London held over 109bn yuan in customer, institutional and interbank deposits by the end of 2011, a pool of liquidity that will help London to grow as a renminbi centre.

CNY AND CNH

Although there is a single source of renminbi – the People's Bank of China in mainland China – the currency has some different characteristics depending on whether it is held onshore or offshore... The two pools of renminbi trade in effectively different markets because the currency is not freely transferable to and fro across the border. The industry has labelled the offshore pool with a pseudo currency code – CNH – to distinguish it from onshore pool – CNY. CNH is widely used as the name for the global offshore renminbi market, centred in Hong Kong.[1]

1 SOURCE: *LONDON: A CENTRE FOR RENMINBI BUSINESS* – BOURSE CONSULT, APRIL 2012

In addition, it offers a range of renminbi-denominated products and services in the retail, corporate and institutional and interbank markets. The problem for London is the lack of awareness of its renminbi offering, an issue that the banks are trying to resolve. "We need to keep growing and that growth will come through education," says Gooding. "We need critical mass and we need volumes, not for FX, but for other products."

"As banks, we need to educate our clients to do more RMB activities. It's at the heart of the story," says Lintern. "It is possible to do a lot more in terms of financing and settling in renminbi than companies are currently doing."

"The major obstacle, paradoxically, is the lack of a market," observes Boleat. "As the market develops, there will be greater liquidity, and as there is greater liquidity, more people will use it. The priority is to increase the volume of business."

For treasurers, the internationalisation of the renminbi brings with it considerable opportunities. By billing, invoicing and receiving in renminbi, companies will be able to save money on their FX margins. "Corporates who see this as opportunity to transform treasury and the supply chain to be renminbi-denominated will have a competitive advantage," says Lintern.

So how is internationalisation of the renminbi likely to work in practice? "I don't think we'll turn on our Reuters screens one day and see that the renminbi has been internationalised," says Gooding. "It will be internationalised once we can borrow it and lend it freely without controls on the market. But we think that for trade, it will be very open and very free within the next six years."

At present, Hong Kong is the only offshore clearing and settlement centre for the Chinese currency, a situation that does not seem likely to change in the short term. This means that London will need to 'piggyback' off the infrastructure that Hong Kong already has in place. But the PBOC announced earlier this year that it is developing a new international payment system, known as China International Payment System, that will be compatible with SWIFT and make it easier to settle cross-border payments in renminbi.

China likes to take a gradual approach with new ideas, and experiment. Then, if the experiment is successful, it significantly ramps up its efforts. With renminbi internationalisation, the pace of change is now set to be rapid, as the example of Hong Kong shows. Lintern points out that Hong Kong boasts some 600bn yuan in deposits, up from nothing less than two years ago. "As long as the regulators feel the market is responding in a responsible, measured fashion, they will let it grow very quickly," he predicts.

So if China is to be the economic giant of the world in 2030, what will the next 20 years bring for its currency? Gooding predicts that the renminbi bond market will take off; the only issue is where. "The next step for market development is hedging tools. Once that's in place, and it doesn't happen overnight, there will be huge growth in the bond market," he says. Then there is the issue of control. "China still has currency controls, capital controls and interest controls," says Boleat. "The more these are liberalised, the more the market will grow." And will the humble renminbi one day be grand enough to knock the mighty dollar off its perch? Gooding believes it will be a reserve currency within the next 10 years. "I'm not sure it will overtake the dollar," he says, "but it will probably overtake the euro and sterling."

Sally Percy is editor of ***The Treasurer***

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LINDA YUEH ON RENMINBI

"The Chinese have said that they cannot be in the right place in the world with their economy in 20 years' time without a convertible currency," Bloomberg Television economics editor Linda Yueh told ACT members who attended the association's summer keynote event in London in June 2012.

"The Chinese are not clear whether they want to liberalise," she added. "They want to see if they can make the renminbi tradeable offshore without opening up their financial sector, which has its own fragilities."

Yueh warned of a Chinese banking crisis due to a legacy of non-performing bank loans made to state-owned enterprises that no longer exist, although she added that she had been issuing this warning "for the past 15 years".

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