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The Chinese Renminbi

The path to liberalization

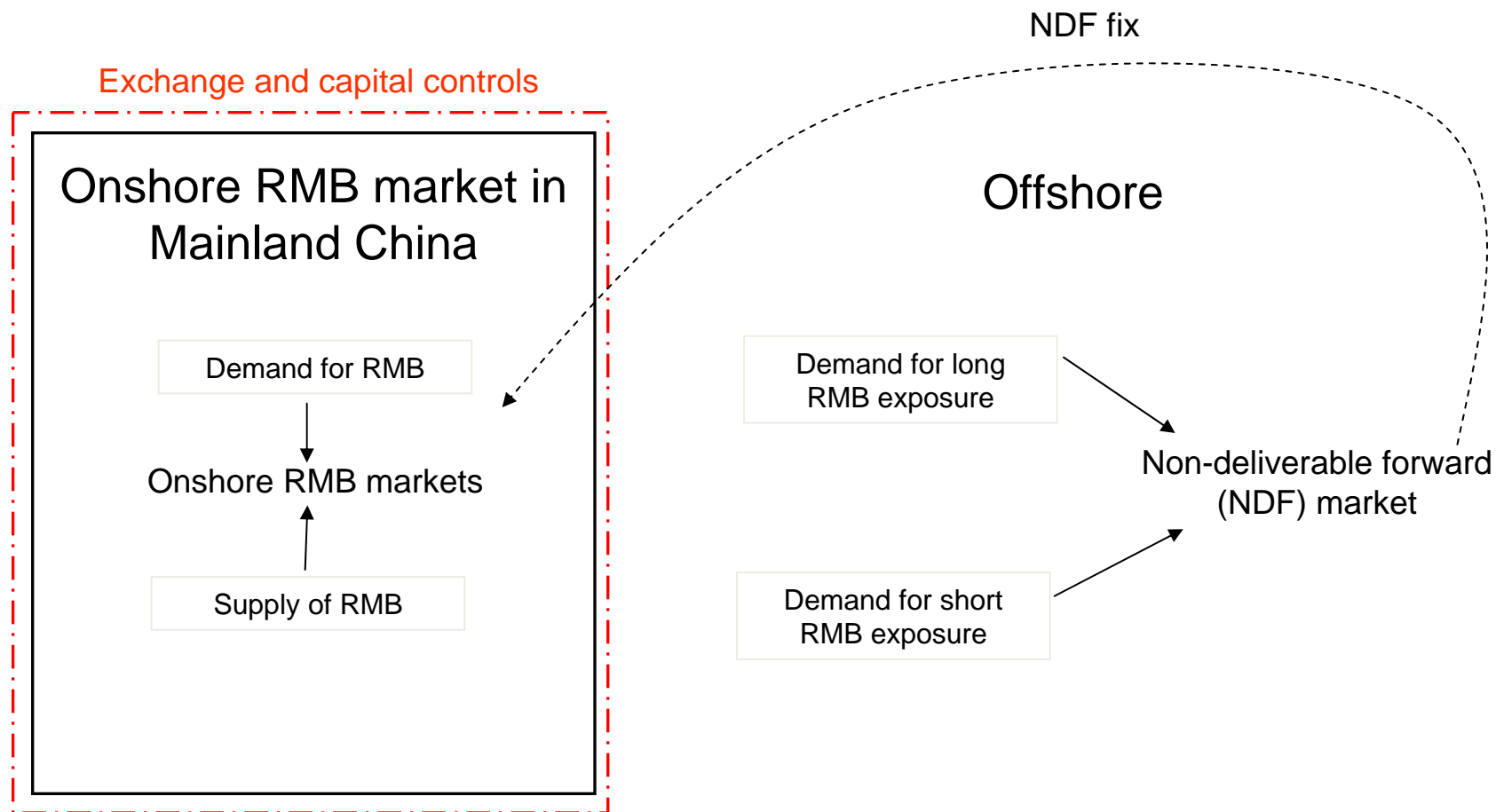
Key terms & definitions

RMB:	Renminbi, official name of Chinese currency (Literally, “The People’s Currency”)
CNY:	Unit of Chinese currency
CNH:	Renminbi based in Hong Kong and accessible globally (Fully deliverable within Hong Kong, and soon Singapore, London)
NDF / O:	Non-deliverable forward / option Offshore hedging / risk taking vehicles

Background...

- July 2005, USD peg is lifted with minimal one-time revaluation of 2%. New currency regime is implemented which allowed the RMB to trade within a tight daily band.
- RMB rises close to 25% between 2005 and 2011 (from a rate of 8.27 RMB for \$1 to about 6.4 RMB for \$1).
- July 2010, People's Bank of China (PBoC) and Hong Kong Monetary Authority (HKMA) introduce the offshore RMB market (known as CNH) with three objectives in mind:
 - Global integration (RMB to be used as settlement currency for cross-border payments, contract negotiation, commodity exchange, and so on).
 - Internationalization (greater access to more participants globally).
 - And ultimately, create an alternative to the USD as the world's reserve currency.

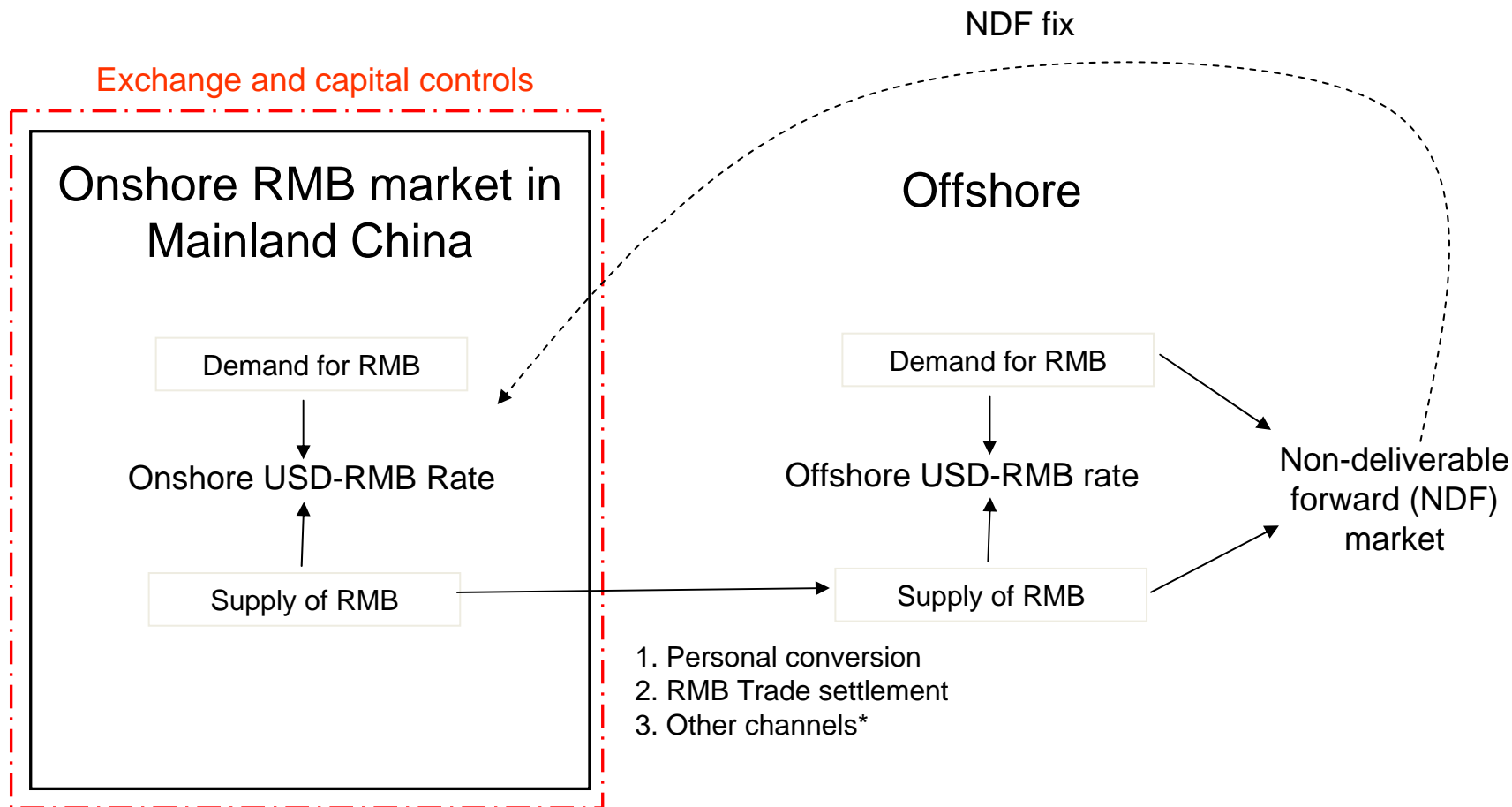
Earlier, RMB was a strictly domestic currency



Source: HSBC FX Strategy

Offshore RMB (CNH) introduced

However, capital control regime remains mostly unchanged



Source: HSBC FX Strategy

* Including central bank swaps,
outward direct investment

The Renminbi: Onshore RMB (CNY)

Co-existence of three markets

- The official domestic currency of the People's Republic of China is the Renminbi (RMB). Onshore RMB is referred to as CNY.
 - Currency closely held and circulated within China.
 - Limited hedging products available.
- PBoC closely monitors and controls the type and the amount of capital that is allowed to flow across Chinese borders.
- In general, 'in' is easier than 'out'.
- Key participants: Chinese institutions or individuals and US firms with onshore entities or subsidiaries registered with the Central Bank access and use RMB *within* borders to carry out regular business practices.

The Renminbi: Offshore RMB (CNH)

Co-existence of three markets

- CNH is the two-way, fully convertible, fully deliverable version of the Chinese currency accessible *outside* country's borders.
 - Accessible to global participants, but trades must be cleared through selected centers, currently Hong Kong (Singapore and London coming).
 - Standard FX hedging products available.
- CHN cross-border settlements to/from the Mainland allowed but quota in place for accessing local onshore rate
 - Quarterly quota equivalent to one day's turnover.
- CNH spot rates closely linked to CNY but there is 'basis' exposure as market continues to develop.
- Key participants: International corporations, investment firms, hedge funds, pensions, individuals.

Basis between onshore & offshore RMB

Supply & demand dynamics at work



Source: Bloomberg, HSBC Risk Advisory

The Renminbi: Offshore RMB hedge (NDF/NDO)

Co-existence of three markets

- The offshore derivatives market gives global participants the ability to hedge or express speculative views on RMB.
- The entire suite of FX products are available, and the liquidity is greatest as compared to onshore CNY and offshore CNY markets.
 - NDF: Non-deliverable forwards
 - NDO: Non-deliverable options
 - Structured deposits, FX-linked notes, exotics, structured derivatives
- There are no restrictions on this market, it trades outside of the borders of the Mainland.
- Key participants: International corporations, investment firms, hedge funds, private equity firms, pensions, insurance companies.

Renminbi exchange rate risk

A one way bet?

- There is consensus from business, academia, and policy for further RMB appreciation.

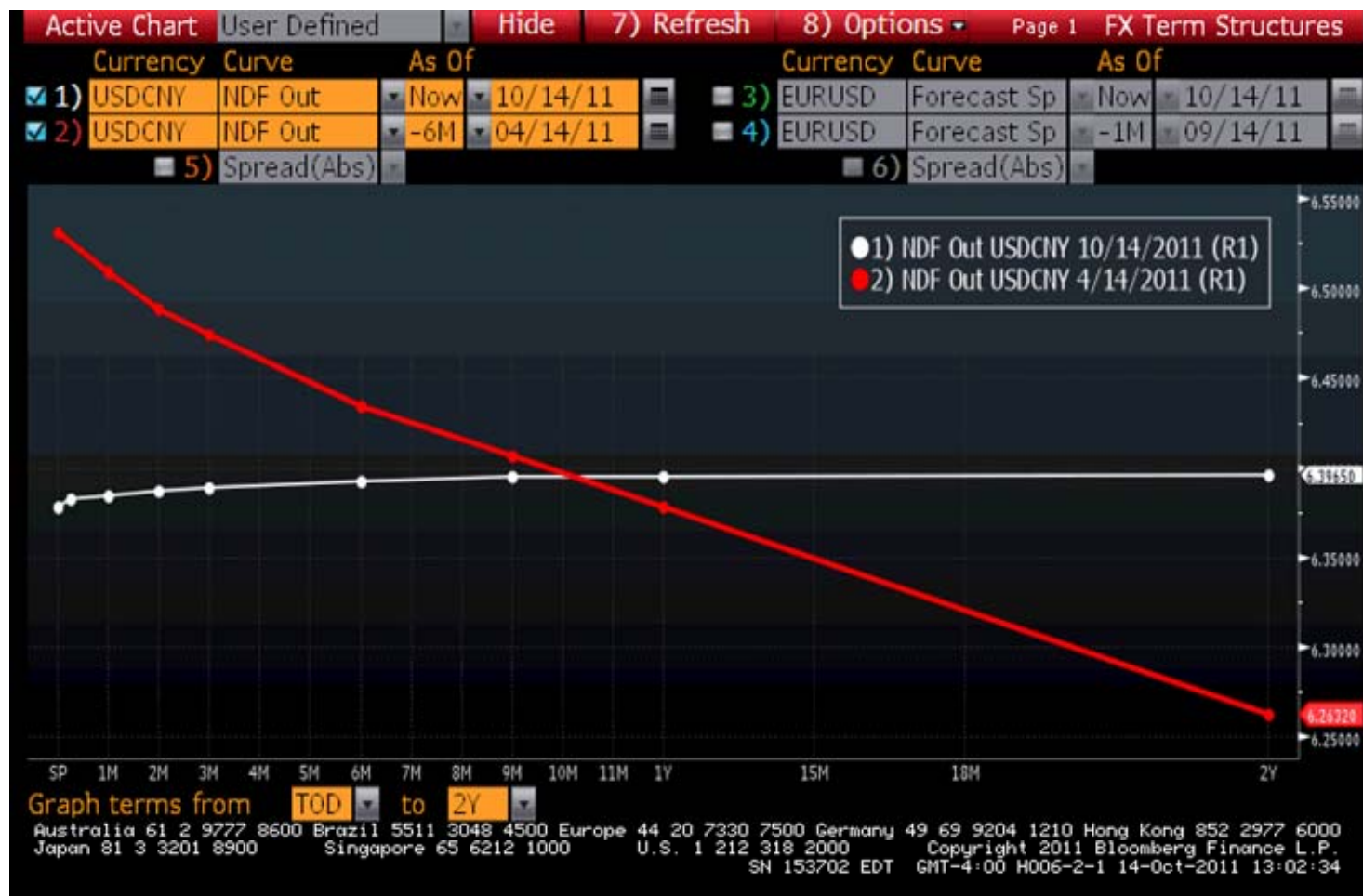
- Winners
 - US-based corporations and institutional investment managers that are long cash flows, balance sheets, equities, bonds, deposit accounts denominated in RMB.
 - Purchasing power of Chinese institutions and individuals in other currencies.
 - Inflation in China

- Losers
 - China's export engine
 - China-based institutions that hold USD-denominated assets (i.e. US treasury bonds).
 - US firms that source product from Chinese suppliers, denominated in RMB.

- The winners for the most part do not hedge, while the losers actively do.
 - This asymmetry further fuels RMB strength (in a self-fulfilling prophecy).

Forecasting the Renminbi

Is there wisdom in crowds?



Source: Bloomberg, HSBC Risk Advisory

Forecasting the Renminbi

Is there wisdom in crowds?



Source: Bloomberg, HSBC Risk Advisory

Forecasting the Renminbi

Is there wisdom in crowds?



Source: Bloomberg, HSBC Risk Advisory

The CNH impact

What does this mean for participants?

Onshore

- Corporations
 - More options to invoice and settle trade; more options to manage FX risk.
 - Some more options to fund offshore.
- Investors and individuals
 - Still limited ability to interact with offshore.

Offshore

- Corporations
 - More options to invoice and settle trade; more options to manage FX risk.
- Investors
 - Access to deliverable RMB products, more investment options and positive yield.
- Individuals
 - Access to RMB exposure.

To invoice in RMB or USD?

- Historically the norm for cross-border dealings involving the Mainland has been to negotiate contracts, invoice, and settle in USD.

- Why?

For one, for legacy reasons.

- Historically, global bias for doing business in USD.

And two, the scheme may be more profitable for Chinese exporters.

- Additional margins built into USD prices.

- CHN encourages migration away from USD invoicing. This is expected to grow over time.

To invoice in RMB or USD?

- **H&M Looking At Possibility To Pay Chinese Suppliers Directly In Yuan**

From WSJ, 20-Sep-2011

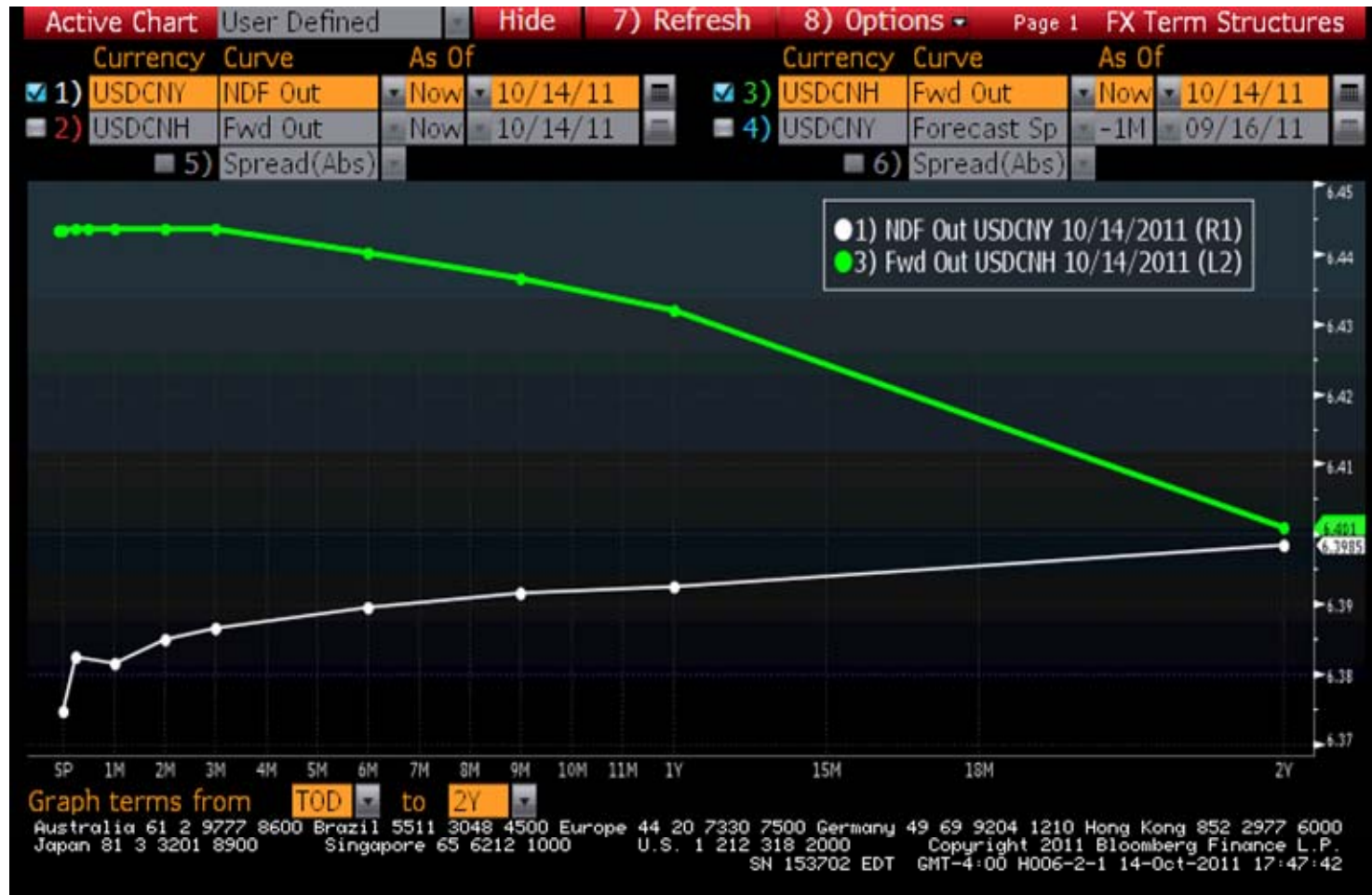
"We pay our suppliers in USD, because it has been and still is a global currency. But as China's economy grows and following a number of step-by-step deregulations for the Chinese currency, the yuan is becoming increasingly accepted," Nils Vinge, head of investors relations said, adding that H&M is studying the possibility of paying directly in RMB, without confirming when or whether it will become a reality.

**Vinge added, "we look for what is simplest, most practical and effective. We report in Swedish Krona, and our Chinese suppliers report in their currency. And as the dollar, the transaction currency, fluctuates, our suppliers have to add a risk premium. They also have currency exchange charges, and also they may have to pay to hedge dollars. If they can cut costs by charging us in their own currency it will be easier. And cheaper for us. If payments are more efficient, everybody profits."*

Offshore RMB (CNH) asset markets

- Strong demand for the RMB currency encourages offshore bond issuance and equity IPO activity (denominated in CNH).
- HSBC estimates:
 - Issuance of offshore bonds denominated in RMB (called dim sum bonds) will reach RMB 230bn. Most notably Caterpillar and McDonald's have issued RMB-denominated bonds in the territory.
 - By 2015, RMB stocks will account for 15% of Hong Kong's total market cap and 20% of stock turnover.
- RMB deposits in Hong Kong are expected to top RMB 1 trillion by year-end 2011 (i.e. 7% of Hong Kong's total market cap).

Convergence of CNH and NDF curves



Source: Bloomberg, HSBC Risk Advisory

Trade Settlement

- Companies globally and nationally in China can now settle their trade in RMB, a departure away from strict USD settlement.
- RMB settled trade accounted for close to 10% of China's total trade settlement in the first half of 2011.
- If settling trade in Hong Kong, there are no restrictions.
 - US based manufacturer with offshore buyer, invoiced in CNH.
 - US based institution with offshore suppliers who wish to be paid in CNH.
- The restrictions apply once you cross the Mainland border.
 - US based institution with supplier located in China.

Cross-border channels

- Cross-border payments must be trade-related to avoid restrictions.
- Paying a vendor in the Mainland is allowed as long as:
 - Counterparty is an approved Mainland Designated Enterprise (MDE), and
 - Counterparty is located in 1 of 20 designated provinces.
- There are quotas for this activity however which currently stand at \$1.2bn per quarter (equivalent to 1 day's turnover).

Green light for FDI into China

- *SHANGHAI, Oct 14 (Reuters) - China has formalised a pilot scheme to allow foreign businesses to invest in the country with yuan legally obtained overseas, as the country moves to internationalise its currency. The People's Bank of China (PBOC), China's central bank, and the Ministry of Commerce on Friday issued documents detailing rules aimed at governing yuan foreign direct investment (FDI)...*
- The rules apply to offshore enterprises, economic organizations and individuals.
- **The offshore RMB must come from legitimate sources, including cross-border trade settlements. RMB profits remitted offshore, share transfer, offshore RMB bond issuance, RMB securities issuance and other legitimate channels. Cross-border RMB direct investment into real estates should follow the exiting rules and approvals concerning Foreign Investment in the Real Estate Industry .**
- **RMB Foreign Direct Investments cannot be invested, directly or indirectly, into negotiable securities and financial derivative, nor used for entrusted loans.**
- For investment projects over RMB300 Million, and those related to finance guarantees, investment companies by foreign Investors, industries under macro-economic control, the endorsements from Provincial Administrative Departments of Commerce are required.

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