

Trade Expansion

The internationalization of the RMB is underway—
what does that mean for trade settlement?

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Six months after its inception, a pilot renminbi trade settlement plan is gathering serious momentum. In addition to the scheme's commercial advantages, the frequent revision and relaxation of its terms by the People's Bank of China has helped boost already burgeoning interest.

At present, corporate attitudes to RMB trade settlement appear to fall into three broad categories:

- Pioneering early adopters that started settling their trade transactions in RMB shortly after the its launch.
- Those that are aware of the plan are interested to learn more and want to gain a better grasp of its technicalities.
- Those that have heard about the scheme but do not currently see it as relevant to their business.

One of the most striking features of these demographics is the number of companies in the second group keen to translate interest into action. In a recent informal poll of several hundred SCB clients active in Asia, more than 40 percent indicated that they were highly interested in exploring RMB trade settlement.

It is also evident that the Chinese government is seriously committed (see "Commitment" below) to the RMB trade settlement scheme, which represents the second of four stages in the internationalization of the RMB. (The first stage was the circulation of RMB to China's neighboring countries; the third is its use as a store of wealth by individuals, enterprises and financial institutions; and the fourth is its use as a significant reserve currency.)



RMB trade settlement
presents opportunities for
importers and exporters



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The second, and current, stage carries long-term implications. Widespread use of RMB as an international trade settlement currency represents a substantive step towards the fourth stage of global reserve currency status, particularly in conjunction with other factors such as ongoing economic development and liquidity.

Commitment

A measure of the Chinese authorities' commitment to the scheme has been its steady expansion and enhancement. When launched in July 2009 the scheme was available only to a restricted list of Mainland Designated Enterprises in Shanghai, Guangzhou, Shenzhen, Dongguan and Zhuhai. These companies were only permitted to use RMB as the transaction currency with their trading partners in Hong Kong, Macau and the 10 ASEAN member countries, and only then for genuine underlying mercantile trade transactions.

A series of developments since then indicate that the Chinese authorities are serious about expanding the scheme in an orderly yet substantive manner. For example, cross-border RMB transactions are no longer limited to mercantile trade, with service transactions now also permitted.

December 2009 saw a further extension of the scheme, as overseas enterprises were permitted to open nonresident RMB accounts at the pilot locations in China to facilitate cross-border trade with Chinese enterprises registered within the same pilot location. A further concession has been extended

to holders of onshore nonresident RMB accounts in Guangdong province, who can now fund transfer with an overseas trade settlement account (typically in Hong Kong) in the same name. Geographic expansion of the scheme also is under way, with Tianjin recently added as a sixth pilot location.

While all the above represent steps in the same direction, one of the most striking changes was among the most recent. On Feb. 4 China announced that A or B grade trade participants (i.e., those with good track records for compliance and payment of duties) no longer needed to apply for MDE status to make import payments. This has major implications; in Shanghai alone some 16,000 enterprises are eligible to participate in RMB trade settlement when making import payments.

Opportunities: Exporting to China

One increasingly important factor driving greater adoption is commercial leverage. The introduction of the scheme means that influential Chinese buyers have little motivation to unnecessarily assume the risk of settling their import purchase invoices in foreign currency. In the case of larger buyers—such as state-



owned infrastructure organizations—this is now becoming a point of competitive differentiation. Companies prospecting for business from such buyers are finding that an inability to settle in RMB can mean lost business.

A further benefit for exporters that are able to settle in RMB is the growing perception of the currency as a store of value, with many assuming that this status will become more pronounced as the RMB continues to internationalize. A few cash-rich exporters (and especially those contemplating future mainland investments) may be prepared to hold RMB-denominated assets in longer-term assets, such as RMB-denominated bonds (of which there has been some issuance in Hong Kong). Other corporates with more immediate need for liquidity are seeing the RMB's likely appreciation as a means of reducing costs. For example, an exporter might receive an RMB-denominated letter of credit from a Chinese importer and use that to raise a USD loan, while hedging the position in the offshore nondeliverable forwards market. When the transaction completes, the expectation is that the costs of hedging the transaction against the importer's functional currency was lower than before (see box "Saving on FX Hedging").

Opportunities: Importing from China

Settling in RMB saves the supplier the currency hedging costs, which should be reflected in lower pricing. Furthermore, there are other potential savings for buyers, such as reduced administrative costs to the supplier of receiving RMB. Statutory foreign currency reporting requirements do not apply, so the administrative costs are lower and the exporter has to deal with fewer government bodies in order to complete a transaction. Under the new RMB cross-border settlement process, eligible Chinese companies that receive export proceeds in

Saving on FX Hedging

The following scenario illustrates how RMB trade settlement can reduce FX hedging costs:

A supplier based in Hong Kong with USD as its functional currency is exporting goods to a Chinese buyer. To cover the associated FX risk, for a six-month transaction, in March 2010 the buyer could have purchased a USDCNY forward contract, in China, with a mid-rate around 6.83. The Hong Kong supplier may have previously been reluctant to carry this hedging cost, as the non-deliverable forwards market required the settlement of the notional to be borne by the supplier, who was previously receiving USD.

Now, since the supplier receives the RMB in Hong Kong, it is more likely to accept NDFs, and in March 2010, could purchase a USDCNY 6 month NDF at 6.73, representing a 1.5 percent saving in hedging costs. For a USD 5 million trade settlement, when the notional is settled one year hence, it represents a \$ 75,000 saving in supply chain costs, incurred by the buyer, which could be shared between the buyer and supplier through revised product pricing.

RMB can present a customs slip, RMB contract and invoice. They can then receive the RMB immediately, as well as enjoy a more streamlined tax rebate process. Because the whole settlement process is expedited, the supplier benefits from a faster payment cycle and lower DSO. All this adds up to lower total frictional costs, which can ultimately benefit both buyers and suppliers.

One of the greatest opportunities for western buyers is to find competitive Chinese suppliers that currently operate only in the domestic market, but are prepared to countenance new export business on the basis of RMB settlement. Given the sheer scale of Chinese manufacturing industries, there are potentially thousands of such undiscovered (in the export sense) suppliers. These suppliers are an untapped resource from western buyers' perspectives, both in cost/performance and in developing more resilient supply chains through access to a portfolio of cost-effective supply sources.

Nevertheless, accessing these suppliers requires that they achieve MDE status, which is a challenging step. Fortunately, some major trade banks offer support services that assist suitable potential Chinese exporters in completing this process, upon introduction by buyers with which the bank has a relationship.

Reality check

While the ability to settle transactions in RMB represents a significant opportunity for buyers and suppliers, individual circumstances will dictate whether it is viable. One important consideration is whether an overseas buyer has access to competitively priced import finance facilities in RMB. Obviously, a major factor here is the buyer's banking relationships; if the buyer has established relationships with major trade banks with a network presence throughout Asia, then it is more likely to have access to such facilities.

Another important element is buyer willingness to assume RMB positions. For those who do not wish to do this, converting to RMB settlement is more readily achievable where two-way trade exists, or where the buyer's treasury policy enables hedging in the non-deliverable forward market.

From the perspective of Chinese exporters considering RMB settlement, buyers' bank relationships also can influence whether the time and cost for exporters to attain MDE status can be justified. Foreign banks authorized to settle RMB that have an established trade pedigree and strong presence in the ASEAN countries can prove invaluable by creating a critical mass of RMB buyer relationships.