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Measuring Value®
The RMB abroad

Among China's action points in responding to the global crisis and its own downturn are two interrelated initiatives - expand and diversify export markets and tie trading partners into more efficient and stable bilateral arrangements, some associated with transaction and reserve currencies. While the Western media is stressing the importance of growing household consumption in China's domestic market, China is pursuing a recovery programme for all of its historic growth drivers - exports, fixed asset investment, and household consumption.

But when it comes to household consumption, China is strategising about growing household consumption in new markets around the world as well as at home.

To expand and diversify export markets, China is promoting more of its manufactured goods in fast-growing markets that have historically not been of interest to MNCs. These include much of the developing world, in Central, South, and Southeast Asia, Africa, and South America. The promotion activities always begin with a top level political declaration of closer economic cooperation and are implemented through free trade agreements, counter-trade agreements, investment, education, and technology support, and, increasingly, with a role for the China currency, the yuan, or renminbi (RMB).

The projection of RMB into banking and commerce outside China has moved quickly, essentially debuting in the State media discussion in late 2008. Madam Wu Xiaoling, until her recent retirement a vice governor of the PBOC, had already announced in December that China planned to pilot the use of the RMB for trade settlement with eight neighboring countries. When Premier Wen announced at this year's National Party Congress that the RMB will be useable as a settlement currency for trade with Hong Kong and Macau, more was already underway. This month, an MOU was formally concluded launching trade settlement with RMB in Hong Kong, and immediately the first deals were concluded and announced. Along with the currency events, we are seeing increasing integration of financial service providers across Greater China, enabled through policy changes and specific MOUs and implemented through M&A, branching, and strategic alliances.

What is China looking to accomplish?

With details that have been filled out since then, the policy can be tied to some key long term objectives that are useful to understand.

No convertibility - Recently the Chinese media has quoted senior officials who emphasise that China is developing an "international role" for the RMB, not "internationalising" it. The essence of this distinction is that convertibility and capital account liberalisation are inevitable, but no timetable is being proposed and certainly not a timetable related to the current push of the RMB into its new international role.

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A powerful, integrated Asia - In his keynote presentation at the Boao Forum for Asia 2009 Annual Conference this April, Premier Wen discussed the increasing use of RMB in the region. Along with the broader use of a single currency in the region, which would increase the efficiency of trade settlement with China, he was expecting free trade agreements and other forms of cooperation to create progress toward an integrated Asian market of 1.9 billion people by 2010.

Hong Kong's future - Of the five cities in China approved to pilot RMB settlement of trade bills, four are in the Pearl River Delta. Hong Kong has been given a central bank facility of RMB 200 billion and a legal platform to market RMB-denominated corporate bonds. Three Hong Kong banks, Bank of China Hong Kong, HSBC, and Bank of East Asia have received approval to manage RMB trade settlement when the rules are completed.

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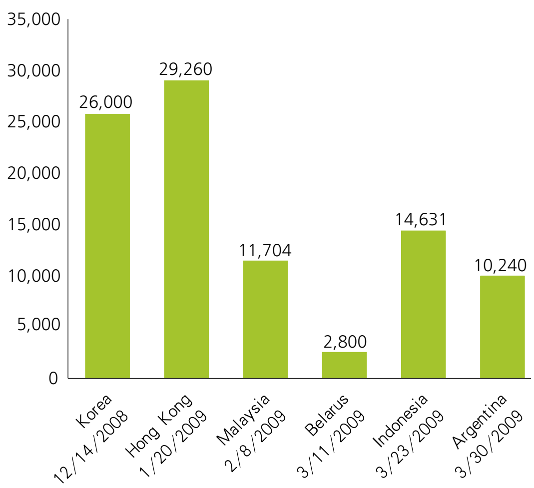
Shanghai's future - Among the channels for outbound RMB are provisions China has made for some central banks reserves, for example in Korea and Argentina. Recently senior banking officials have noted that there is no reason that China's RMB could not account for more than 3 percent or the reserves held globally by 2020, displacing the Japanese yen as the fourth largest reserve currency. The same reports mention that 2020 is the target date for Shanghai to have evolved into an international financial centre.

A World Currency - Although in March, PBOC Governor Zhou Xiaochuan called for an international currency, (something modeled on the Special Drawing Rights under IMF management that were established in the 1960s), this topic has not been raised recently.

China's currency swaps, in US$ millions



Source: People's Daily and China Daily

Some key measurables

So where is China actually going on the currency issue? First, projecting RMB abroad creates some ambiguity in China's attitude about a strong US dollar, China's huge holdings notwithstanding. At this year's Boao Forum for Asia, the talk was much more about the RMB in the Asian region. Some senior government delegates from ASEAN countries even proposed developing an independent Asian currency for trade settlement and reserves. The RMB already is circulating informally in Vietnam, Pakistan, Russia, and five central Asian countries. As early as December 2008, the PBOC signed currency swap agreements with Korea, Malaysia, and Hong Kong as a step toward using the RMB more broadly for regional trade settlement. Belarus and Argentina and most recently Brazil have been added. At present, public announcements of RMB swap agreements or trade settlement agreements have totaled US$95 billion (with an additional $15-$20 billion pending for Brazil). [The following table shows China's six RMB - receiving partners in the order the agreements were reached.] A facility that involves trade settlement and a loan package against oil shipments is being completed with Brazil, the second Latin American country in an RMB related-deal. China is being flexible in using various permutations of swaps, credits, aid, loans, forward purchases to tailor deals to the financial situation of the counterparty and their trade situation with China.

A Paradox

Although China's official policy toward RMB foreign exchange rate changed in mid 2005, from a US dollar peg to evaluation of a basket of currencies, an examination of multilateral rate fluctuations since then demonstrates that the RMB still moves in steady relationship to the US dollar and fluctuates both short and long-term against other global currencies, including the Euro, British Pound, and Japanese Yen, in virtual synchronisation with the US dollar. This creates an intriguing paradox in China's announced policy with the currency.

On the one hand, numerous senior officials have made clear the current policy is to hold the value of the RMB steady. In fact, it has traded in the range of 6.82 to 6.87 for a year, with a brief retreat to 6.8838 in December 2008. Fluctuations against other major currencies have tracked those of the US dollar. For practical purposes, up to this point, "steady" means moving with the US dollar.

On the other hand, for six months now, the promotion of the RMB as an international settlement currency, along with considerable public discussion of the US dollar by senior Chinese officials, has emphasised the relative stability of the RMB, in contrast to the US dollar. The viability of the RMB as a regional trading currency to a certain extent relies on demonstrating this. Simply put, it is not possible to maintain the RMB steady against the US dollar and at the same time demonstrate that it is more stable than the US dollar. Something has to shift.

Looking ahead

China sits at the hub of a growing number of bilateral currency swap agreements, with its stable currency and massive FOREX holdings. Given that the currency is non-convertible, nominally RMB facilities of any sort lock the swap partner into using their RMB to purchase Chinese goods, or go to secondary exchange markets, which do not yet exist at scale in legal or actual terms. In Korea and Argentina, RMB reserves constitute now a large part of funds accessible to the central bank to back the won and peso in general. As of December, Korea had facilities worth about US$80 billion, a US$20 billion non-emergency currency swap agreement with the Bank of Japan, a US$30 billion agreement with the US Federal reserve, and a US$30 billion agreement (US$26 billion equivalent in RMB and US$4 billion in dollars) with China's PBOC to call on RMB for reserves.

The RMB's use outside China, as a settlement currency and even as a local secondary currency, is already more widespread than the six countries with which formal swap agreements have been reached. And we can expect more swap agreements and extensions of export credit soon. If the RMB gains traction through these developments, we would expect exporters to China will begin looking for RMB settlement, including exporters of inputs into China's processing trade, natural resources, foods and grains, and other major items on China's import bill.

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Some important events will likely occur. First, an increasing international role for the RMB will expose it to market forces in a way that has never happened before. As an optional settlement currency in Asia and around the world, RMB will now compete with the US dollar, in a limited but indicative way. Traders stipulating contract terms will have to make assessments related to value, stability, and availability of the settlement currency. Toll manufacturing, import-export equilibrium, and the function of China's import-export companies will change markedly. The Asian region as a whole could establish a somewhat distinct trading currency profile from the remainder of the world.

Secondly, with growing trade in the intra-Asian circuit, and continued movement toward free trade agreements engaging China, S.E. Asia and South Asian countries, the availability of the RMB for settlement will add efficiency to cross-border, regional supply chains, stabilise settlement arrangements, and reduce hedging costs. China's trade with ASEAN countries exceeded US$230 billion last year. As Premier Wen suggested, high levels of trade, FTAs that are scheduled to be in effect by 2010, the relatively good health of Chinese and ASEAN banks and insurers, and the historic high levels of supply chain integration could together help "decouple" the huge Pan-Asia development platform from a lagging and uncertain recovery in the developed West.

We believe the changes in RMB policy and practice to be extremely important for business, something that can add efficiency to MNCs and Chinese companies with supply chains that cross regional boundaries, reduce currency risk and hedging costs for companies with significant imbalances in their China trade in either direction. It will also provide an alternate store of value for central banks, commercial banks, and enterprises able to access RMB offshore. MNCs and Asian trading companies will rework their trade terms to take advantage. Finally, it will accelerate the increasing influence of Chinese banks in the global financial system. Branches of the Bank of China may be expected to open quickly in the wake of bilateral trade deals.

How extensively the RMB establishes itself in these new roles is as much dependent on US dollar trends as policy and practice changes in Beijing. Like every aspect of the current global situation, that leaves a large measure of uncertainty. Still, the more successful the RMB is in its new roles, and the more RMB circulates for trading and other purposes outside China, the more pressure will build to reduce administrative management of exchange rates, open more windows for currency transactions, and open more official channels for moving RMB funds across PRC borders.

No doubt, much about the new RMB initiative remains unsettled, even regarding one of the first steps, which is to make the RMB a trade settlement currency across the Mainland - Hong Kong border. Unsettled issues relate to the absence of a trading market for the currency and the controls in place on holding foreign currencies inside China and holding RMB outside China, as well as moving capital account funds in either direction. But we believe permitting the moving of large amounts of RMB abroad and creating facilities and mechanisms to make it a major settlement currency are logically among the Chinese government's current priorities in addressing global currency risks and securing China's own economic recovery.

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Forthcoming in Measuring Value®
RMB: Cash flowing and cash trapped

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