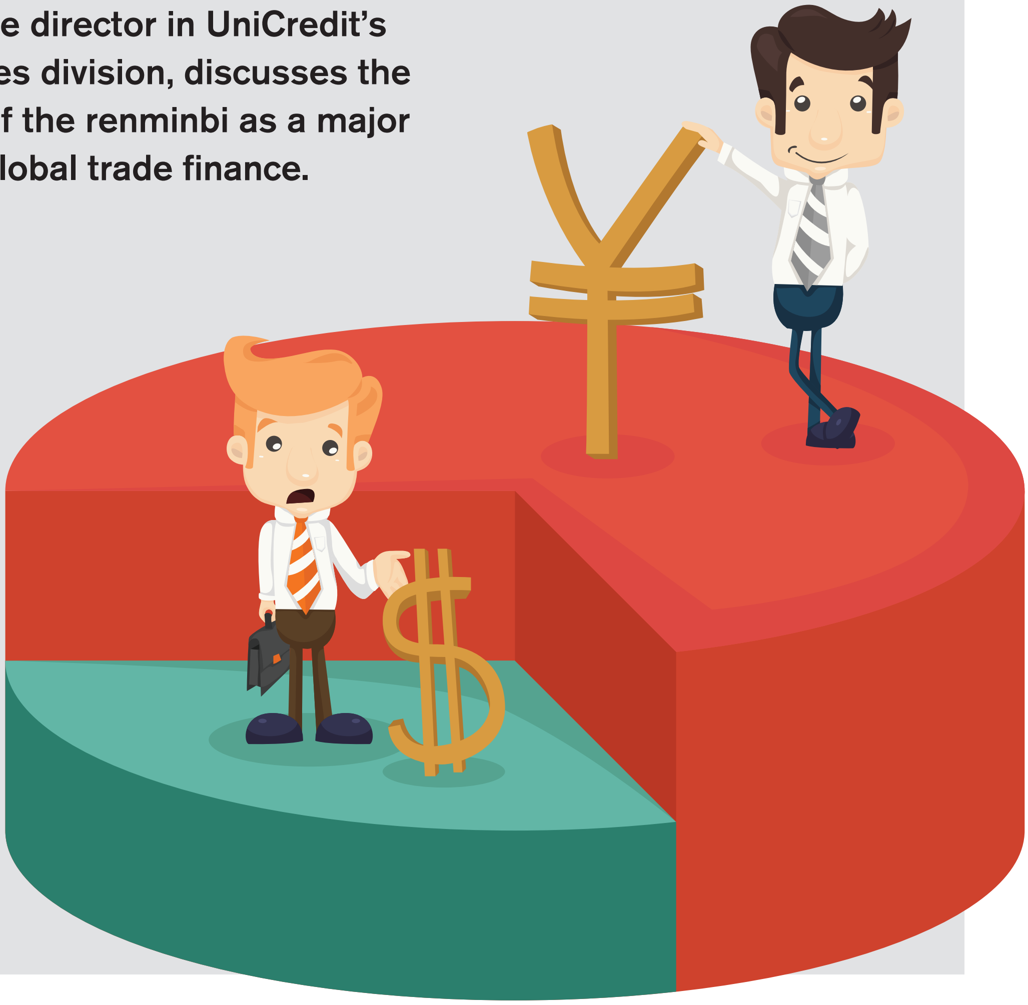
***Elke Doser*, an associate director in UniCredit's Asia Pacific trade services division, discusses the impending emergence of the renminbi as a major settlement currency in global trade finance.**



¥uan's rise equals dollar's demi$e?

The Chinese currency goes by many names. While it's generally referred to as the "kuai" on the streets of China, some refer to it as the "yuan" and others as the "RMB", an acronym for "ren min bi," or "the people's currency." In the international arena, the RMB is designated by the ISO codes CNY, which stands for Chinese Yuan and designates the onshore form of the currency, and CNH, which refers to the offshore form.

By whatever name you call it, it is now impossible to ignore the Chinese currency. Indeed, the RMB has become a staple topic in financial and political journalism, buy and sell-side equity and fixed income research, and particularly in trade finance. Given this seeming ubiquity, one might be surprised to learn how little the currency is actually used to settle cross-border payments with China.

The currency that comes closest to the RMB in terms of global payments (in value) is the Swiss franc (CHF). According to SWIFT, the RMB accounted for 1.42% of total global payments in February 2014 versus 1.45% for the CHF. With the exception of this number, the two countries couldn't be much more different – consider, for example, the sizes of their economies, populations and geographic area. When these levels of payment are considered in proportion to each country's exports, it becomes evident how much room for growth the RMB has. The People's Republic of China is estimated to have accounted for 10.7% of global exports in 2013 while Switzerland accounted just 1.51%, making it the 20th largest exporter in the world. Thus, only about 12% of China's total payments are transacted in its domestic currency, while this number is close to 100% for Switzerland. The comparison is even starker when you consider the US, as the proportion of international payments settled in US dollars (USD) is equivalent to more than 500% of that nation's annual export value.

The evolution of the RMB

Of course it isn't fair to compare a currency like the CHF with a more than 250-year history with an emerging currency such as the RMB. When considered on its terms, the evolution of the RMB has been quite impressive particularly with regards to trade. The RMB marked its debut in the global trade finance industry five short years ago, when a cross-border (offshore) trade settlement scheme was introduced in 2009. The pilot scheme allowed 365 mainland designated enterprises (MDE) to settle their trades in RMB. Since then, the list of MDEs has been extended to include all Mainland Chinese exporters; free trading of the RMB has been introduced in Hong Kong and, according to SWIFT, more than 1,050 financial institutions in over 90 countries have taken to doing business in the currency.

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That being said, statistics from the People’s Bank of China showed that trade settlement in RMB accounted for 18% of China’s total trade in 2013, an astonishing rise from just 2% in 2010. But still, outside of Hong Kong, which accounts 83% of the RMB trade settlements, imports and exports to and from China are settled in other international currencies. This relatively low level of payments in RMB is all the more surprising when one considers the advantages which accrue to Chinese companies which settle trade in RMB rather than in USD. Key among these advantages is the fact that they are no longer exposed to currency risk and avoid hedging costs. In fact, Chinese corporations settling transactions in RMB can actually profit from a natural hedge as their payables and receivables are invoiced in the same currency.

Cross-border trade

There has been a great deal of speculation over why the RMB accounts for such a small portion of China’s cross-border trade settlement. One potential reason is that currency risk on a trade settled in RMB does not disappear, but actually shifts to the non-Chinese counterparty. While some of China’s trade partners might consider settling transactions in RMB an attractive opportunity to diversify their currency portfolios, most would likely demand price reductions from the Chinese exporter to offset currency risk. However, such price cuts would likely not be granted as doing so would require the Chinese company to reveal how they price currency risk.

In addition, the counterparties would have to consider Chinese regulations governing the invoicing and payment for goods and services transacted in RMB. The Chinese entity would have to provide the government with trade documents verifying that the payment was related to a genuine trade and procurement and submitting these documents could delay payment. That being said, these regulations have already been relaxed: at the time of writing, the trade settlement bank is permitted to pay the Chinese exporter with the stipulation that it receives supporting documents within a reasonable time frame.

Yet another reason why a Chinese exporter may elect to not settle a trade in RMB is related to financing costs. Letters of credit (LC) – a standard cross-border payment method in China – are mostly invoiced in USD because discounting an LC in USD costs the Chinese exporter less than it does in RMB due to the lower USD interest rate. In this case, it is clearly more convenient for both parties to settle transactions in USD.

The obvious exception to this case is when the USD is a foreign currency for both parties. It is not surprising that the RMB is widely used as a trade settlement currency in East Asia, where it has supplanted both the USD and Euro as the dominant reference currency. Chile, India and South Africa are leading the trend of trade settlement in RMB, and have helped the aggregate value of trade settled in the Chinese currency to quadruple between 2010 and 2012. In a nutshell, while it is difficult to shift trade settlement from USD to RMB terms within well-established trade relationships, the latter is an attractive alternative to the usual currencies in emerging trade relationships.

Despite these seemingly manifold impediments to the growth of RMB-denominated trade payments, there are numerous factors that are leading China’s trade partners to increasingly consider the RMB.

These include:

- the growing negotiating power of Chinese companies, which should allow them to increasingly “force” their international customers and suppliers to settle trade in the RMB if desired.
- the internationalisation of the RMB – in addition to Hong Kong, Taiwan, Singapore, London, Luxembourg and Frankfurt are all competing to become the first or strongest providers of RMB settlement in their respective regions. This means that trade settlement in the Chinese currency is destined to become increasingly convenient for companies in these areas.
- the value of the RMB – although the RMB saw a spate of depreciation earlier this year, most analysts expect it to appreciate further in the long term, making it more attractive for non-Chinese companies to hold and use the currency.
- the increasing amount of RMB held in offshore deposits – as international corporations begin to accrue assets denominated in RMB, they are likely to be more willing to accept the currency as a basis for trade settlement.

Future prospects

In the big picture, the RMB is substantially underweight as a reference currency for trade finance and payments in general. The reasons are various and comprehensible – for now. However, there are at least as many reasons to conclude that the emergence of the RMB as major settlement currency in global trade finance is more a matter of “when” than “if” – get ready for the “kuai”.

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