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Settlement Program Next Step Toward Making Renminbi a Global Currency

Prompted by its growing economic power and the worldwide financial crisis, China is accelerating its efforts to establish the renminbi (RMB) as a global currency.

Now the third largest economy after the United States and Japan, China has experienced exponential export growth in the past decade, with its cross-border transactions settling in foreign currencies including the US dollar (USD) and the euro (EUR). China's export strength has allowed it to build up a considerable foreign exchange (FX) reserve, which it has invested in USD-based assets such as US government bonds and notes.

The recent global financial crisis has increased USD and EUR volatility, and China's heavy reliance on foreign currency has exposed it to currency risks related to both trade settlement and overseas investment, prompting China to accelerate efforts to elevate the RMB to a more significant role as an international currency.

An Ongoing Effort

Since it was first issued in 1949, the RMB has always been a restricted currency. To move toward making the RMB more readily convertible into other currencies, China has gradually expanded its use outside of China, allowing neighboring countries and cities that have bilateral trade to become testing grounds.

For instance, since 2004, RMB has been allowed in Hong Kong, one of the world's key financial markets, under certain restrictions. Hong Kong residences are allowed to convert and hold RMB under pre-set daily limits, and certain retail industries in Hong Kong are allowed to accept RMB in cash. Furthermore, in 2007, China permitted its financial institutions to issue RMB-denominated bonds in Hong Kong. Such steps have created RMB liquidity outside of China, but mainly in the Hong Kong retail sector.

However, in order for RMB to become a global currency, there must be a broader demand for the currency in overseas markets. So, late last year China indicated its intention to allow RMB to be used in cross-border trade settlement, and in July 2009 it released details of its RMB Offshore Trade Settlement Pilot Program.

The program allows pilot enterprises in China — currently 400 of them — in five pilot cities to settle in RMB for their cross-border trade transactions with enterprises in Hong Kong, Macau and Association of Southeast Asian Nations (ASEAN) countries*.

Still, there is much planning and preparation to be done in order for RMB to become a global currency. The likely next steps include expanding the list of pilot enterprises and pilot cities for cross-border trade settlement, allowing RMB to be used for settlement of non-trade activities, and increasing the number of RMB-denominated hedging and investment products.

Pilot's Impact Across Asia

Today, when Chinese firms export goods to Hong Kong, Macau and ASEAN countries, since most such trades are settled in USD, companies in these locations need to exchange their domestic currency for USD to settle the transactions. As a common practice, Chinese exporters build the expected USD forward rate into the selling price, knowing they must convert the trade settlement in USD to RMB in China to pay for raw material and expenses. The result is an inefficient process whereby two FX transactions are conducted on both the export and import side.

Under the RMB Offshore Trade Settlement Pilot Program, companies can settle international trade in RMB, eliminating one foreign exchange transaction, which can impact the selling price. Furthermore, importers in Hong Kong, Macau and the ASEAN countries may be able to obtain a better FX rate due to economies of scale, since they will have larger FX volume than individual Chinese exporters.

The USD remains the dominant settlement currency in intra-Asian trade. However, as the pilot program expands and more companies in Hong Kong, Macau and ASEAN countries participate, there should be stronger liquidity in RMB outside of China.

Longer-term Implications

The wider usage of RMB in cross-border trade settlement will reduce foreign exchange exposure for companies in China, eliminating the currency mismatch between receivables and payables.

For companies in other Asian countries, the use of RMB will create a new foreign exchange exposure — although it is widely perceived that RMB will not have wide currency fluctuations compared to other currencies, since it's still considered a restricted currency. Furthermore, because domestic currencies such as the Singapore dollar, Malaysian ringgit and Thai baht are either restricted currencies or not widely used as international settlement currencies, companies in some Asian countries will need to convert their domestic currencies into an international settlement currency, be it USD or RMB.

If the RMB someday achieves global currency status, the advantages (or disadvantages) will vary depending on the company's size, its currency exposures and its bargaining power. Hence, companies need to follow the latest developments and regularly communicate with their business counterparts in China.

* The ASEAN countries include: Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam.