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Settlement Program Next Step Toward Making Renminbi a Global Currency

In conjunction with its growing economic power, China continues to take steps toward establishing the renminbi (RMB) as a global currency, a development that would shake up the status quo and could in years ahead have a variety of effects — both positive and negative — on US multinationals.

The global financial crisis has prompted China — now the world's third largest economy after the United States and Japan — to accelerate the process of repositioning its currency.

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 the country to build up a considerable foreign exchange 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 created concerns over the future value of the USD. In addition, 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.

Should the RMB become a global currency, China would have less exposure to currency fluctuations, especially in times of global financial crisis.

An Ongoing Effort

Since it was first issued in 1949, the RMB has always been a restricted currency. To accelerate the process of 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. Later, 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 also be a demand for the currency in overseas markets. So, late last year China accelerated the process by indicating its intention to allow RMB to be used in cross-border trade settlement. Subsequently, in July 2009, China released details of its RMB Offshore Trade Settlement Pilot Program.

The program allows pilot enterprises in China — currently 400 of them — to settle in RMB for their cross-border trade transactions with enterprises in Hong Kong, Macau and Association of Southeast Asian Nations (ASEAN) countries*. This is the most significant step China has taken to date to bring the RMB into the international arena.

Still, there is a lot of 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 for cross-border trade settlement and allowing RMB to be used for settlement of non-trade activities.

Impact on US Corporations

For years now, the USD has been the default currency for international trade settlement. US exporters and importers have enjoyed the convenience of conducting business in their home currency with no foreign exchange risk. Also, having the world's reserve currency, US companies can easily raise funds in all parts of the world at a relatively low cost due to the demand for USD-denominated assets.

So what impact will China's efforts to make the RMB a global currency have on US corporations?

In the near term, US companies can take advantage of the RMB Offshore Trade Settlement Program if they are conducting cross-border trade transactions with any of the 400 pilot enterprises in China through subsidiaries in Hong Kong, Macau or Southeast Asia. In such cases, US firms could consider using RMB as a currency for settling those transactions.

Longer term, should the RMB become a global currency, US multinationals could reap a foreign exchange (FX) benefit. Since the United States imports more goods from China than it exports to the Asian nation, when a US-based multinational buys from China in USD, the Chinese exporter prices in the FX risk. Chinese exporters, as a common practice, build the expected USD forward rate into the selling price. Should RMB become a global currency, US-based multinationals would be in a position to command a better FX rate due to economies of scale, since US-based multinationals will have much larger FX volume than individual Chinese exporters.

On the other hand, if in future years the RMB challenges the USD's position as the world's dominant reserve currency, the reduced demand for USD-denominated assets might mean that US companies will be required to pay higher financing rates.

China's efforts to globalize the RMB are in their very early stages, and no one knows how long this process might take or what exactly the future holds. Hence, at this time, there is not much US companies can do regarding the future use of RMB in the open market, other than to closely follow future developments in the pilot settlement program and the expanded role of RMB in bilateral trade arrangements.

If you have questions about this article, you can e-mail Jeffrey Cheng, Assistant Vice President, Account Management, for Deutsche Bank in Hong Kong.

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