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RMB cross-border trade settlement scheme: What are the potential implications?

- **The direct benefits to Chinese enterprises of the Renminbi (RMB) settlement of cross-border trade would be the alleviation of the costs and risks of exchange rate fluctuation. Furthermore, the pilot scheme represents an essential step toward the internationalization of the Chinese currency.**
- **To Hong Kong, the RMB trade settlement scheme would substantially increase RMB liquidity in Hong Kong, bring new business to the Hong Kong banking industry as they may offer different kinds of RMB financing products and services and therefore, further enhance Hong Kong's importance as an offshore RMB centre.**

How does RMB trade settlement work?

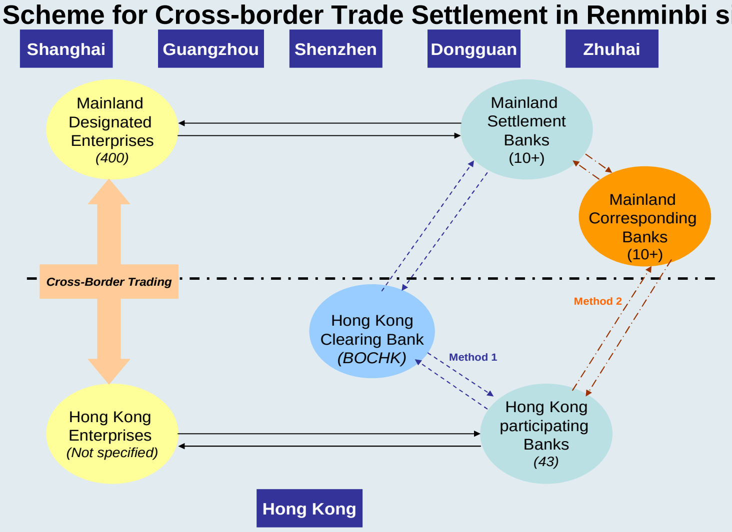
On July 6 2009, the pilot scheme for cross-border trade settlement in Renminbi was jointly launched by the Mainland China and Hong Kong authorities. Under this scheme, Mainland designated enterprises in Shanghai, Guangzhou, Shenzhen, Dongguan and Zhuhai will be able to use RMB as the transaction currency when trading with designated non-Mainland enterprises in Hong Kong, Macau and ASEAN member countries.

The Chinese official websites have disclosed 365 eligible enterprises for the pilot scheme, mostly in the manufacturing and trading industries. Guangdong province (Guangzhou, Zhuhai and Dongguan) has selected 182, Shenzhen has selected 91 and Shanghai another 92 pilot enterprises.

Up to now, about ten domestic Mainland banks have gained the qualifications to engage in cross-border trade settlement with RMB[1]. Besides, three foreign banks incorporated in Mainland China (HSBC, Standard Chartered and Bank of East Asia) also gained the qualifications. In Hong Kong, a total of 43 banks are members of the RMB clearing and, hence, could participate in the scheme so far. These participating banks can handle RMB cross-border transactions either through a clearing bank in Hong Kong or/and a correspondent bank in Mainland China. In Hong Kong, the Bank of China (HK) acts as the sole RMB clearing bank for the time being.

Chart 1 presents how RMB settlement works in Hong Kong.

Chart 1: Pilot Scheme for Cross-border Trade Settlement in Renminbi since July 2009



[1] Domestic banks include, but are not necessarily limited to, Bank of China, Industrial and Commercial Bank of China, Agricultural Bank of China, China Construction Bank, Bank of Communications, China Minsheng Bank, Industrial Bank, China Merchants Bank, Shenzhen Development Bank, Ping'an Bank, as more banks will obtain qualifications gradually.

Moreover, participating banks in Hong Kong can conduct RMB interbank transactions with banks in the ASEAN member countries and Macau, which are eligible for conducting cross-border trade settlement in RMB. Such interbank transactions need to be settled and cleared through the RMB clearing bank. These transactions are, however, subject to the applicable statutory and regulatory requirements in the relevant overseas jurisdictions.[2]

Currently, apart from obtaining RMB from customers' deposits, Hong Kong participating banks can also obtain RMB either through interbank transactions using available RMB liquidity in the Hong Kong's financial system, or through their access to the RMB market on the mainland, subject to certain limits set by the mainland authorities. In short, Hong Kong banks can source RMB funding by means of: (i) deposits from customers; (ii) currency conversion through the clearing bank in Hong Kong or a Mainland correspondent bank; (iii) interbank funding to borrow RMB funds from the clearing bank in Hong Kong, from banks that have engaged the clearing bank in Hong Kong for RMB settlements and/or from a Mainland correspondent bank. RMB borrowing through the mainland interbank market is subject to People's Bank of China (PBC) imposed conditions designed to avoid unreasonably large RMB fund inflows into Hong Kong.

The scheme greatly widens Hong Kong's RMB services for cross-border trade enterprises, and brings additional channels of RMB funding to Hong Kong banks. Table 1 shows the key changes of RMB banking services in Hong Kong. It removes the limit for banks in Hong Kong to lend out RMB, and broadens their RMB funding sources.

Nevertheless, there are still some temporary limitations of the Pilot Scheme. As a new program, the inefficiency of customs declarations and lack of coordination between authorities depressed the enthusiasm of enterprises to settle trade in RMB[3] but the situation is gradually improving as the government tries more favorable measures on customs declarations and export rebates. One more development which is still in the making is RMB settlements for small and medium enterprises (SMEs), which cannot yet qualified for the pilot scheme. In fact, the People's Bank of China has been working with relevant government departments to add more qualified SMEs into this scheme as a trial exercise.

Table 1: Major changes in RMB services provided by non-Mainland participating banks

	Before RMB trade settlement	After RMB trade settlement
Deposit taking	Hong Kong residents and " Designated merchants" (those belonging to the seven categories of retail sales, catering, accommodation, transportation, communications, medical and educational services) can open RMB accounts with Hong Kong participating banks	Same as before Enterprises located in areas covered by the Pilot Scheme with a trade background can also open RMB deposit accounts with Hong Kong participating banks. The deposits should be originated from trade transactions. This is a breakthrough development as pilot enterprises can keep their RMB proceeds overseas. The RMB funds held in such deposit accounts can also be used for investing in RMB bonds issued in Hong Kong
Currency Exchange	Individuals can exchange RMB for HKD or vice versa, with RMB 20,000 upper limit for per person on each transaction by cash, or with RMB 20,000 upper limit for per person per day by deposit account. Designated merchants can exchange RMB from their normal course for HKD (one-way) without limit	Same as before Trade enterprises can exchange HKD for RMB based on actual trade transactions, or exchange RMB from their normal course for HKD without limit
Remittance	Hong Kong residents can remit RMB to their own accounts with their Mainland banks, subject to a daily limit of RMB 80, 000 per account. Also, issuers of RMB bonds in Hong Kong can remit proceeds from bond issuances to the Mainland.	Same as before Trade enterprises in the selected areas outside Mainland China can also remit RMB to the pilot cities on the Mainland or vice versa, based on actual trade transactions.
Trade finance	Not available	RMB trade finance can be provided for trade transactions with Mainland designated enterprises, while the finance amount should not exceed the corresponding trade transaction amount, and should be paid to the Mainland designated enterprise directly. The interest rates on the trade finance will be determined by the banks concerned on a commercial basis
Cheques	RMB cheques drawn on current accounts held with Hong Kong participating banks can be used both in Hong Kong and on the Mainland. Within Hong Kong, customers can make payments and fund transfers in relation to subscription and acquisition of RMB bonds. On the Mainland, RMB cheques can be used for consumer spending in Guangdong Province, subject to a daily limit of RMB80, 000 per account.	RMB cheques can be used for transferring funds between the "same-name" accounts held by the same enterprise at different banks for pooling RMB funds for trade settlement. Enterprises can also use RMB cheques to make payments for the subscription and acquisition of RMB bonds.

Source: HKMA

[2] Supervisor's memo,Hong Kong Monetary Authority Quarterly Bulletin, September 2009

[3] After Bank of China (Hong Kong) launched the first cross-border RMB settlement on July 14, 2009, there were 66 trade settlement transactions amounting to RMB42.8 million between Hong Kong and Mainland China within a month (source: HKMA).

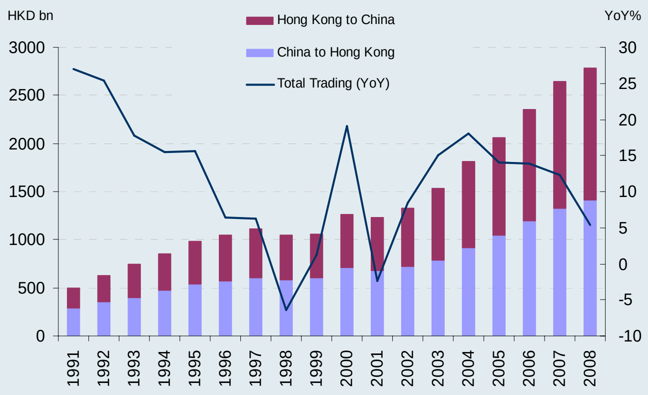
RMB cross-border settlement: Some potential consequences

Consequences for Hong Kong

The provision for RMB trade finance is important because overseas companies, including those in Hong Kong and Macao, may have limited sources for RMB. RMB trade finance will enable them to settle transactions directly in RMB with their Chinese partners who are pilot enterprises. This will, in turn, encourage more overseas companies to use RMB trade settlement with authorized enterprises. Further, Hong Kong is already the economic area with the most extensive RMB circulation outside Mainland. Since 2004, RMB services of deposits, remittances, currency exchange and credit cards have been introduced to Hong Kong, followed by the introduction of RMB cheques in 2005 and the issuance of RMB bonds by mainland banks in 2007. From July 2009, foreign banks incorporated in Mainland China can issue RMB bonds in Hong Kong, and HSBC (China) and Bank of East Asia (China) have already issued 1 billion and 4 billion RMB denominated bonds respectively. Besides, the Mainland government intends to issue Chinese government bonds worth 6 billion RMB in Hong Kong on September 28. This moves clearly demonstrated the central government's support for Hong Kong as an international financial center to further develop RMB business.

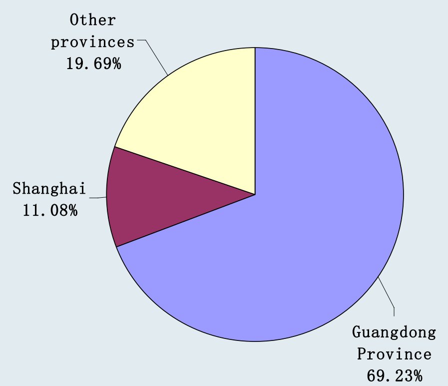
Under this pilot scheme, Hong Kong should benefit most for its gigantic trading volume with Mainland (namely HKD 2,783 billion in 2008) which is concentrated in Guangdong and Shanghai –two of the authorized areas- with 80% of total trade (Chart 2&3).

Chart 2: Mainland China Total Trade with Hong Kong



Source: CEIC

Chart 3: Share of Mainland China Trade with Hong Kong



Source: CEIC

The scheme should provide an increasing revenue stream for Hong Kong banks, especially those with strong parental support in Mainland China. More Mainland banks will probably try to expand their presence in Hong Kong.

At the same time, the RMB settlement will increase Hong Kong banks efforts to attract RMB deposits, and to some extent, it might raise the RMB deposit rate, which could lead to a massive shift from Hong Kong dollar deposits to RMB deposits. This is particularly true in the current conjuncture of a very low interest rate in HKD deposits.

Finally, an important challenge for Hong Kong is the lack of products to hedge RMB risk (other than the very narrow NDF market). The development of RMB forward and futures markets in Hong Kong is clearly a must.

Consequences for China

Chinese exporters who are pilot enterprises will benefit the most from this scheme as they will be able to better manage and hedge the currency risk (of RMB appreciation against foreign currencies) and reduce the transaction cost from currency conversion. In such regard, this should improve the overall cost structure and profit margin of Chinese exporters. The pilot scheme also indicates the further opening of China's financial markets, with the aim of making RMB a major clearing currency in trade deals with counterparts. This is particularly true for neighboring countries, and it will help to foster the trade between China and the rest of Asia, not only Hong Kong.

No major impact on RMB internationalization should be expected immediately given the relatively small size of the pilot project. However, the extension of the project in a relatively short period of time is likely.

In the long run, without full opening of the capital account items, the scope of foreign counterparts in RMB settlement is still limited. Along with the increase of settlement using RMB, more pressure towards the appreciation of RMB is expected.

Finally, it seems clear that, despite the recent bold measures, there is still a long way to the globalization of the RMB currency.