2011 has had its fair share of major events, politically, economically and environmentally, but it will be remembered as the year in which a new global currency was truly born. Although the progress made during 2011 is part of a longer journey towards currency liberalization, we have seen a huge acceleration in the use of RMB as a cross-border settlement currency and rapid development of an offshore RMB market. While the offshore market remains relatively small, the speed of its development and long term potential is too great to ignore. This article considers how the RMB is internationalizing, the drivers of this process, and how corporate treasurers can take advantage of new opportunities.

**Progress Towards Liberalization**
The past few years has witnessed the start of a transformation in the way that RMB is traded both within China and offshore. While RMB is a desirable investment currency, it is largely unattractive to borrow in an appreciating currency. An offshore financing market is developing however, centered in Hong Kong, following established offshore market practices and encouraged by the Chinese government. The offshore RMB (known as CNH) is priced differently from onshore RMB (CNY) with a spot and forward market and a fast-growing deposit base, reaching RMB622 billion in September 2011.

**A Transformation in Cross-Border Trade Settlement**
Opportunities for RMB cross-border trade settlement have also developed rapidly since its initial introduction in 2008. Initially, most cross-border transactions settled in RMB were imports into China, which were not subject to restriction. By August 2011, the final restrictions on exporters were lifted, and any exporter in China is now eligible to settle cross-border trade transactions in RMB. Initially, the volume of transactions settled in RMB under the program was low, but as restrictions on exporters have continued to lift, the volume and value of RMB cross-border flows has accelerated, reaching 10% of total trade by mid 2011, with continued rapid growth. More than 67,000+ Chinese companies (more are expected to be approved soon) can now benefit from favourable tax treatment on RMB-settled flows, and non-residents can open RMB accounts in China for cross-border trade, subject to approval from the local governing authority and 10% withholding tax.
Leveraging the Opportunity

The government’s ongoing commitment to liberalization is helping to alleviate companies’ reticence to invest too heavily in China, which has often resulted in the problem of ‘trapped’ cash. Restrictions still apply, but the development of an offshore RMB market and relaxation of cross-border trading restrictions, mean that companies are now in a better position to enhance their trading and financial position in China. A key issue is how to maintain competitiveness whilst maintaining access to liquidity. While there are clear advantages for Chinese companies to settling transactions in RMB, as their foreign exchange risk is eliminated, there are also advantages for foreign companies, particularly those with both payables and receivables in RMB. Currency risk is eliminated and margins preserved as exposures can be netted, enhancing companies’ ability to do business in China without ‘trapping’ cash. However, as the examples further in this article illustrate, there are potential benefits for net importers and exporters too.

Conducting Trade in RMB

An efficient way of buying and selling in RMB is to establish a re-invoicing center supported by an in-house bank, as the following examples illustrate:

Example 1: Buying and Selling in RMB

Company A both pays and collects in RMB through a re-invoicing center. The in-house bank then operates a multi-currency notional pool to borrow RMB or a foreign currency (USD in this example) against an offshore RMB or USD deposit as appropriate (Figure 1). Company A then uses a netting service provided by its bank to optimize cash operations during the transition period. The benefits of this approach are the following:

- No need to verify goods with SAFE
- No bank Pending Verification Approval process is required, accelerating trade and cash flows
- Ability to leverage lower offshore financing rates for temporary overdrafts
- Payables and receivables can be offset, reducing FX exposure
- Greater discipline is introduced into the payment/collection cycle, reducing cash flow ‘spikes’ and minimizing working capital requirements
- Balance sheet costs and trapped cash are reduced

For Chinese distributors/suppliers, FX costs and exposures are eliminated as business is conducted in RMB, and they may also be able to benefit from flexible payment terms. In this instance, Company A would need to settle on a gross basis to maximize sales tax claims based on actual cash settlement.

Figure 1: Buying and Selling in RMB Through a Re-Invoicing Center
**Example 2: Selling to China-Based Distributors**

Company B wishes to sell goods and services to distributors in China in RMB (which could be a third party distributor or a subsidiary of the group) (Figure 2). Third party distributors prefer to use RMB to reduce their purchasing costs and FX risk, while for subsidiary companies, FX exposures can be concentrated offshore to allow more effective hedging.

Company B collects RMB offshore through a re-invoicing center. The company’s in-house bank operates a multi-currency notional cash pool to borrow USD against RMB deposits. This arrangement brings many of the same advantages to those experienced by Company A. In addition, Company B is able to fund future investments in China without increasing currency risk or impacting the balance sheet. Company B would, however, need to consider the potential impact should there be a significant change in offshore liquidity. Secondly, they would need to be selective about which flows to settle in RMB to achieve the optimal level of offshore RMB liquidity, such as covering a 3 year RMB re-investment plan or developing a China-based manufacturing facility exporting goods back to the home market.

*Figure 2: Selling in RMB Through a Re-Invoicing Center*

**Example 3: Buying from China-Based Suppliers**

Company C wishes to purchase goods in RMB both from fully-owned subsidiaries (enabling FX exposure to be concentrated offshore for hedging) and from third party companies (enabling the cost of purchases to be reduced) (Figure 3). This is achieved by processing RMB payments through a re-invoicing center, while an in-house bank borrows RMB in Hong Kong e.g. through a 3 year bond, to fund China exports, with an offshore multi-currency notional pool. Company C can take advantage of a lower offshore financing rate, in addition to many of the benefits outlined in the previous two examples. With little long term bank funding available, however, Company C should assess the potential impact of a sudden change in offshore RMB liquidity, or raise RMB from investors. In addition, the company should select trade flows to achieve the optimum level of offshore liquidity in order to repay the RMB borrowing. In addition, the possible impact of RMB against Company C’s functional currency should be considered.

*Figure 3: Buying in RMB Through a Re-Invoicing Center*
Achieving its Potential

Although there is still a long journey ahead towards liberalization, all companies with an interest in China need to establish an appropriate strategy for trading in China that takes into account their procurement, sales and financing needs. A flexible strategy, supported by the right banking partner, will enable companies to take advantage of new opportunities as they arise. The developments in both the offshore RMB market and cross-border trading opportunities are significant both in promoting RMB as a currency for trade between Chinese entities and their foreign trading partners, but also as a major international reserve currency. As liberalization continues, it is likely that RMB will rapidly become an alternative international settlement currency or even currency of choice, not only for trade involving one or more Chinese entities, but for trade across Asia and globally.

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