

Renminbi threat to dollar shows signs of stalling

News analysis

Cross-border deals settled in Chinese currency have fallen and few foreign groups use it, says **Robert Cookson**

The Chinese renminbi could pose a threat to the international dominance of the US dollar within five to 10 years, the US-China Economic and Security Review Commission warned this month in its annual report to Congress.

But based on the latest data, this prediction might be premature. In contrast to popular perception, evidence from China suggests that the internationalisation of the renminbi is stalling – and in many respects it has barely got off the ground.

In its most recent monetary policy report, the People's Bank of China (PBoC) revealed that the amount of cross-border trade settled in renminbi fell in the third quarter, the first decline since China started using its own currency for imports and exports in June 2009.

"It's quite shocking because things were going so well," says Dariusz Kowalczyk, strategist at Crédit Agricole in Hong Kong. "How fast the renminbi becomes an international currency will depend on how acceptable it is in trade."

Trade is also the main source of renminbi liquidity to the international markets, so the slowdown could affect the price of Chinese currency assets held offshore such as dim sum

bonds. After two years of uninterrupted increases, the total volume of renminbi-settled deals dropped by 2 per cent to Rmb583bn (\$92bn) in the third quarter compared with the previous three months, the PBoC said. As a share of all China's current account transactions, the renminbi fell to 7.8 per cent, from 8.5 per cent in the second quarter, according to Crédit Agricole.

Behind the headline figures, the story is more worrying for Beijing. Bankers say that only a small proportion of the Rmb2,050bn (\$320bn) of trade settled in renminbi since 2009 involved companies outside mainland China or Hong Kong.

"The reality is that virtually none of the major multinationals are trading in renminbi today," says an executive at one of the world's largest banks. Foreign companies, he says, are accustomed to using US dollars and have been put off by the complex regulations that govern the use of the Chinese currency.

As the Financial Times first reported in January, one of the key reasons for the spectacular boom in renminbi trade settlement is that mainland Chinese companies have been transacting with their own subsidiaries in Hong Kong in order to arbitrage between the two markets. This activity abated in the third quarter, bankers say, causing renminbi-settled trade to decline.

According to Swift, the global payments system, more than 80 per cent of all cross-border renminbi payments involve Hong Kong. Only 8 per cent of the transactions are "truly offshore",

in the sense that one leg of the transaction is outside China or Hong Kong.

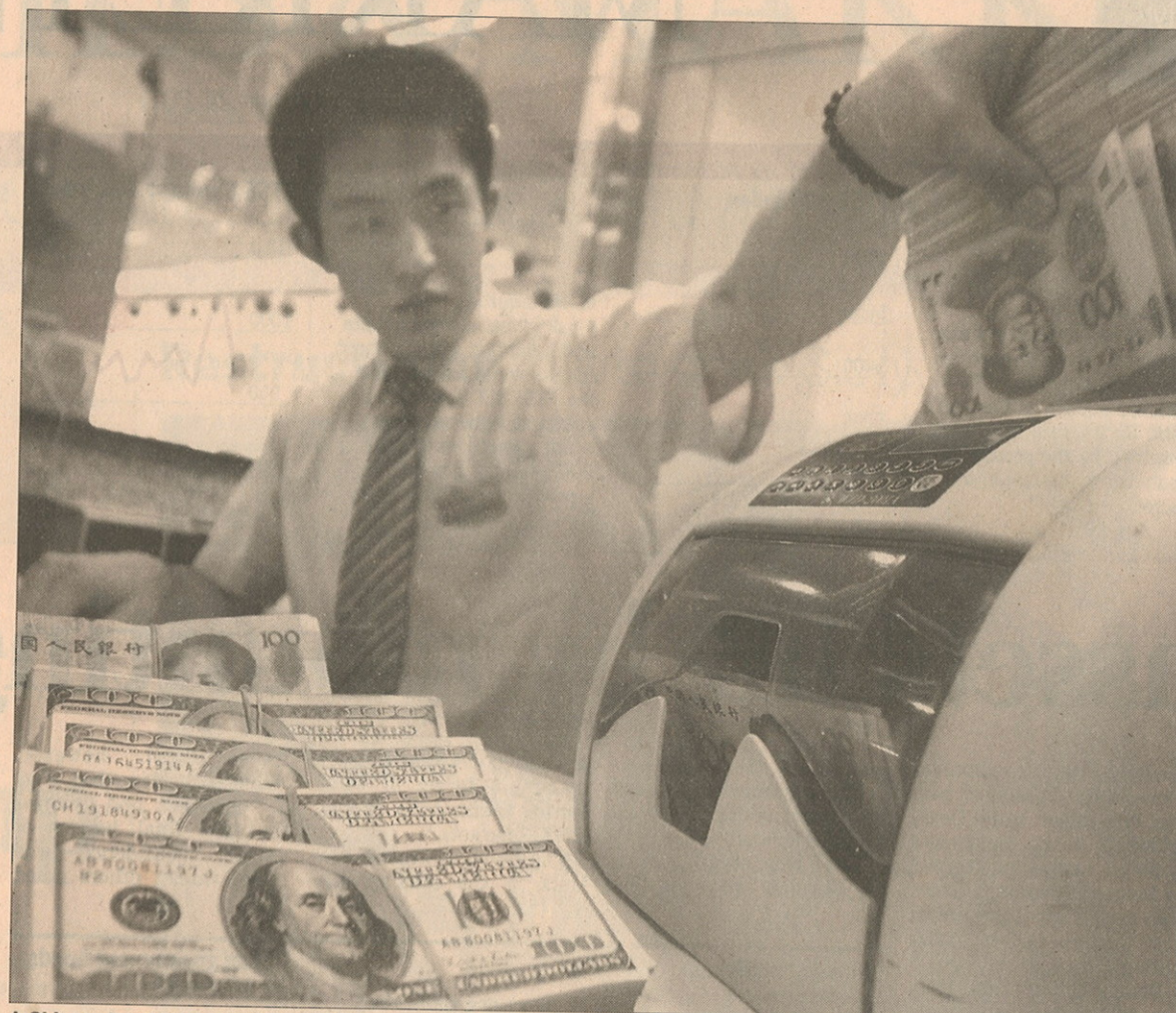
Using public data sources, it is impossible to determine the composition of companies holding renminbi deposits in Hong Kong banks. But according to bankers, they are mostly the subsidiaries of Chinese groups, rather than international companies.

"It would seem that renminbi settlement has not been as successful as official numbers suggest," says Joyce Poon, an analyst at Gavekal, the research firm. An "unknown proportion" of the renminbi trade may be "motivated by the opportunity to access offshore US dollar financing, rather than true renminbi trade settlements", she says.

Bankers say one of the main types of arbitrage works as follows: a Chinese company places renminbi on deposit with a mainland bank, earning an interest rate of about 3.5 per cent. The company then obtains a renminbi-denominated letter of credit from the bank, ostensibly to pay for a shipment of goods from its own subsidiary in Hong Kong.

In turn, the Hong Kong subsidiary takes the letter of credit to a local bank and uses it as collateral to obtain a US dollar loan at a lower interest rate than those available on the mainland. In many cases, the company would also use a currency derivative to eliminate the foreign exchange risk, completing the arbitrage.

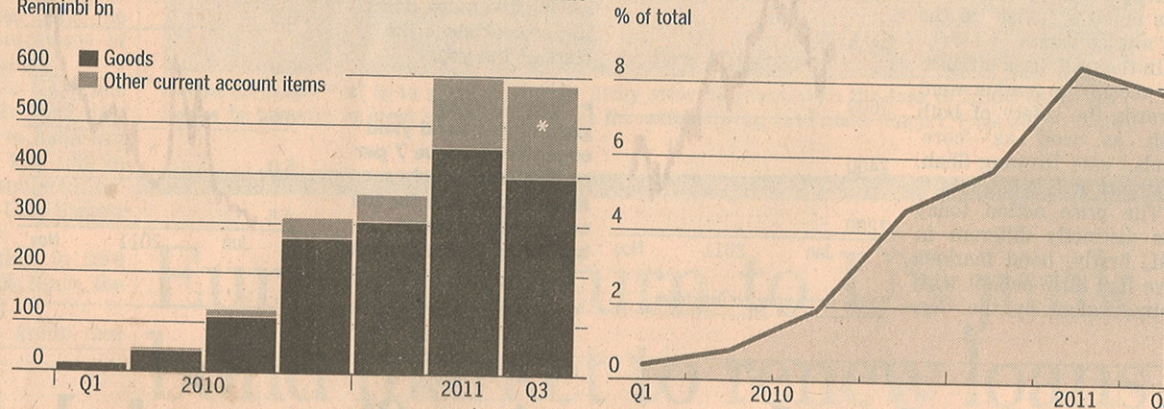
Until recently, this arbitrage proved a boon for both the companies involved and the banks, which have collected handsome fees. The scale of the activity is reflected in the



A Chinese bank clerk counts renminbi notes in Nanjing. The currency has not yet been embraced internationally

Reuters

China current account transactions settled in renminbi



Sources: PBoC; Crédit Agricole CIB

* First decline in history

fact that Hong Kong banks' claims on mainland banks – a statistic compiled by the Hong Kong Monetary Authority (HKMA) that include letters of credit – reached \$222bn as of August, having jumped seven-fold from just \$32bn when the renminbi trade

settlement scheme started in June 2009.

But as dollar liquidity has declined and concerns have risen about their exposure to China, Hong Kong banks have become less keen to lend dollars against letters of credit from the mainland.

Meanwhile, the HKMA has intensified its crackdown on "illegitimate" renminbi payments, threatening banks with penalties if they fail to obtain robust evidence, such as shipping documents, to prove that their customers are conducting genuine

cross-border trade. The renminbi could well eventually rival the US dollar. But until the Chinese currency is embraced by international companies as well as opportunistic mainland groups, US political strategists have little to worry about.