China’s dramatic growth in international trade has made it the second largest economy in the world, as well as the largest exporter. However, the use of China’s currency, the renminbi (RMB), has not grown as extensively as the economic boom. China’s currency has been subject to extensive exchange controls, which has resulted in the U.S. dollar (USD) being used for the majority of cross-border transactions.

The Chinese government has undertaken an extensive process to internationalize its currency, slowly relaxing rules to become a more equal trading partner with other nations. The government wishes to promote international use of the RMB in a three step process:

- **RMB as a global trade currency** – As the RMB develops as a trade currency, businesses outside China become accustomed to using it as payment for goods and services.
- **RMB as a global investment currency** – The goal is to allow the RMB to be invested more freely. Enterprises are now able to move their RMB-based holdings cross-border. Firms want to be able to use the cash that they receive from trade.
- **RMB as a global reserve currency** – The government wants its currency status to match its position as an economic leader. China would like to challenge the USD as a reserve currency.

China’s central bank, The People’s Bank of China (PBOC), with the recommendation of the State Administration for Foreign Exchange (SAFE), expanded the use of the RMB for global trade settlement. China is now encouraging the use of RMB outside of the mainland, with the goal of having the RMB become a fully convertible currency.

Note that the renminbi (RMB) is the name of China’s currency, while the yuan (CNY) is the unit of currency. CNY is the official ISO currency code for China’s currency.

**RMB INTERNATIONALIZATION**

In the past, RMB could only be held inside China and all of China’s internal trade was settled in RMB. China’s currency can now be held and invested overseas. Trade of goods and services in and out of China can be settled in RMB. Trade finance methods are available in both onshore and offshore markets.

Data from Bloomberg shows that RMB-denominated trades accounted for 11% of China’s foreign trading in 2012, up significantly from 2010. The majority of trades,
however, continue to settle in USD. Beyond international trade, RMB payments grew 17-fold from October 2010 to June 2012 per SWIFT data. We expect the trend to continue, as the government continues to relax currency restrictions to the point where most Chinese business enterprises are now allowed to use RMB with their international partners.

Enabling this cross-border flow is the fact that RMB accounts may be opened outside of China, primarily in Hong Kong, but also in other jurisdictions. In addition, foreign companies need not have a legal entity established in China (or Hong Kong) in order to open an offshore RMB account. Also, the RMB now trades directly against the Japanese yen as well as the U.S. dollar, adding depth to the RMB market.

To help further their goal of internationalization, Chinese authorities have announced plans for developing Shanghai into a global financial center, including RMB trading, by 2015. Taiwan is in the process of becoming the second major offshore market after Hong Kong to clear the RMB. International cities, most notably London and Singapore, are making a push to join Hong Kong as centers of RMB business.

Investment opportunities are also growing, as offshore RMB may be used for capital investment. The RMB is now viewed as an asset class, with market participants using the currency as an investment vehicle. Channels exist to issue RMB bonds in Hong Kong (“dim sum” bonds). The RMB Qualified Foreign Institutional Investor (RQFII) program allows investment in mainland China securities with RMB held in offshore accounts. Both of these programs dramatically expanded in 2012.

Capital investment will be helped via regulations issued by China’s SAFE in December 2012, further expanding the use of RMB as a global investment currency, with the intent of promoting the facilitation of foreign direct investment. Investors no longer need to obtain approval to open bank accounts, remit profits, or transfer money between different accounts. SAFE has relaxed limits on the number of foreign currency accounts and the amount of money that can be transferred.

Fig. 1: CNY (RMB) 12-month Price Chart

Source: Bloomberg
SAFE feels that capital inflows have not put significant pressure on China, even with recent appreciation of the RMB. Instead, improvements in international financial controls will allow China to more easily attract capital inflows.

Well before the internationalization initiative, China had been gradually liberalizing its currency and capital markets, partly due to pressure from its trading partners. From 1994 to 2005, the Chinese currency was pegged RMB 8.28 to USD 1. In July 2005, Chinese officials implemented policies basing the RMB value on a daily trading band and basket of currencies but in a tightly controlled range of +/- 0.3%. Tight capital controls on both incoming and outgoing capital were retained.

From July 2005 to July 2008, even with these tight controls, the RMB appreciated by 21%. In 2007, the trading band increased to 0.5%. Due to the global financial crisis, China’s central bank maintained a virtual peg to the USD from July 2008 through July 2010. The trading band was increased to 1% in 2012. The RMB has appreciated over 25% against the USD since July 2005.

**Fig. 2: RMB Price Timeline**

![RMB Price Timeline](source: Bloomberg)

**TRANSACTING IN RMB vs. USD**

U.S. companies have historically believed that negotiating international agreements in USD insulates them from exposure to currency volatility. However, this practice often puts them at a competitive disadvantage compared to companies that transact in local currency.

Shifting to local currency has been a useful solution for trade with many countries. With China’s changing currency regulations, clients are learning that conducting business in the RMB instead of the USD can pay significant dividends. The PBOC has estimated that the administrative cost of transacting in USD is 2-3% higher than dealing in local currency due to embedded premiums.

The acceptance of the RMB as a trading currency and the growth of the offshore market are inevitable. We advise our clients to review their processes and to consider using the RMB in their business dealings with China. As further evidence of the benefits and ease of RMB use, the hedging market is liquid and has been expanding in volume and tenor.
LIMITATIONS
If a transaction is trade-related, then the Chinese beneficiary needs to have an import and export license in order to receive cross-border RMB payments. If the payment is service related, then the Chinese beneficiary does not require an import and export license and is able to receive the RMB payment.

RMB cross-border settlement can be used only for business enterprises, not individuals. Regulations state that individuals in China are unable to receive RMB from overseas, so USD must be remitted for payments such as salaries to individuals. It will then be converted to RMB on-shore.

SUMMARY
The Chinese government has made progress with the three key steps to RMB internationalization. China and its trading partners can now transact, trade, and invest in RMB. International usage of the RMB has been growing, but the RMB will need to expand to transactions unrelated to China in order to become a flexible international currency. There also needs to be elimination of currency exchange controls. When that process is complete, the RMB then will be able to take the final step towards becoming a global reserve currency.

The RMB market continues to evolve, and developments are encouraging. Liberalization of the currency is an ongoing process, and China wants to proceed at a measured pace. The market has experienced exponential change over the last year, and we expect the trend to continue.

PNC offers a library of videos, white papers and articles on doing business in China, including the advantages of dealing in local currencies. PNC’s dedicated team of senior foreign exchange consultants can help you understand the implications of conducting business in the Chinese RMB and provide overall guidance related to the FX markets.