

Financing a growing China

As China takes up its position as a world-leading economy, its demand for financial and professional services from overseas is continuing to grow, writes Duncan Levesley.

We enter the new decade after a tumultuous couple of years for the global financial services industry. The problems are not yet over, but signs of recovery are tentatively emerging. The nature of economic recovery in 2010, and in turn its impact on the financial and professional services sector, remain heavily debated; but one thing economists consistently agree on is the vital role of China.

In a year when companies begin to emerge from their defensive positions of the recession, decisions they make in 2010 will determine whether they prosper, survive or fail. A key factor in these decisions will be their China strategies. 2010 will see China further cement its place among the world's economic leaders, and this year it will become the world's second biggest economy with GDP exceeding that of Japan.

This is not to say that China is without problems in the wake of the financial crisis. There has been a big drop in exports which needs to be compensated for. The Chinese Government's stimulus package of over Yn4 trillion, introduced to combat the effects of the global economic crisis, will be slowly withdrawn, and the 2009 surge in bank lending will be scaled back. However, with 8.7 per cent GDP growth in 2009 (and an even higher rate forecasted for 2010) combined with huge foreign exchange reserves, China is in an enviable position.

Consumer boost

What is more, the fall in exports has led the Government to shift its focus towards the development of domestic consumption. China's high savings rate means that rather than suffering the effects of overleveraged consumerism, relying on cheap debt, as in much of the West, it can focus on unlocking

the vast consumer potential within its own borders. As well as the obvious opportunities for UK companies selling goods into the Chinese market, there will also be an increased need for the financial products required in this process. These will be wide ranging, from insurance, which will free families from having to save for future health and retirement needs, to electronic forms of payment, allowing faster development of the burgeoning internet shopping industry.

China's impressive economic development has been matched by enormous strides in financial services over the past decade, and the pace of development will continue in 2010. On its accession to the WTO in December 2001, China committed to opening up its financial and professional services sector. The results are impressive. Foreign financial firms have been given much greater freedom to do business in China, and UK businesses, with their world leading expertise in this sector, have been at the forefront of this. UK companies are working successfully across the gamut of financial and professional services subsectors, including banking, fund management, insurance, pensions, venture capital, training and education, securities, and legal and professional services; and there are plenty of opportunities for more UK activity in these and many other areas.

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Lujiazui Financial Zone in Pudong, Shanghai is bristling with the signboards of foreign-funded banks

Much progress has been made in the last decade, but it is not all plain sailing. Regulatory approval for the establishment of foreign firms can be time consuming, and restrictions still remain. For example there are investment caps on banking and insurance ventures, and there are limits and constraints on legal work and renminbi-denominated investment funds. In the field of stock exchange listings, the Chinese government has imposed a barrier ('Ordinance 10') against Chinese companies listing overseas, and foreign companies cannot list in China for now. However, it is certain that the regulations will continue to be reviewed and modernised.

Edging towards internationalisation

One of the most notable developments of 2009 was the State Council's announcement in March that Shanghai would develop into an international financial centre by 2020. This plan will necessitate wide-reaching changes in the Chinese financial market. More transparency will be required, as will a modernisation of rules and laws. There will be an increasing emphasis on the use of renminbi in international trade, for growth capital investment, and in bonds and shares. The Shanghai Stock Exchange will open up more to international investment, and this move towards internationalisation may be marked as early as this year by the first foreign company listing on the Shanghai Stock Exchange. There will be opportunities across the board in financial and professional services as the city further expands the array of financial and professional services, activities and institutions that will facilitate its growth into an international financial centre.

UK companies are already well positioned across the Chinese market. UK banks now have the most foreign banking assets in

China, making up 23 per cent of the total, and continue to expand the scope of their business. For example, Standard Chartered now has 15 branches, 33 sub-branches and 1 representative office in China; and their first village bank was set up in November 2008 in Helingeer, Inner Mongolia. Foreign banks can now deal with retail and corporate customers throughout the country in renminbi. This access to the market will be invaluable as more individuals throughout China demand increasingly sophisticated financial products. Furthermore, the growing number of high-wealth individuals has created a huge market for private banking and wealth management.

China's fund management sector has burgeoned over recent years as well, with a staggering increase over the last decade in assets under management. British fund managers have been taking advantage of these opportunities. UK companies have more 'qualified foreign institutional investor' licences than any other European country, and they have also won mandates to manage assets for China Investment Corporation (the sovereign wealth fund), and the state pension fund.

Meanwhile, UK companies are also doing well in insurance, broking and reinsurance, and three of the top six foreign life insurers are British. Market entry and penetration still take time and effort, and the current market share for foreign companies is small, but the potential for growth is huge.

Investment houses are also taking their first steps in the Chinese market, which is opening up with some interesting collaborations on renminbi funds; notably the US private equity firm Blackstone, which established its first renminbi-denominated fund in August 2009 in collaboration with the Government of Pudong, and is hoping to raise Yn5bn for investments in the Shanghai region.

While many Western markets have stagnated, China's economy grew by over eight per cent in 2009, and companies traditionally investing in Europe and North America are looking to this engine of growth for appropriate opportunities. The 'green-tech' sector is seen as particularly attractive, capitalising on a global and domestic demand for environmental technology backed up by government spending and incentives.

UK services in demand

In professional services, foreign law firms are spreading their business, and UK companies are second only to the US in terms of their presence in China. UK professional bodies such as the accountancy institute CIMA have a growing Chinese membership. PwC is now the largest professional services and accountancy firm in China by

Financial hotspots

- China has a large number of major manufacturing and trading hubs, including Hangzhou, Suzhou, Nanjing, Wuxi, Dongguan, Tianjin and Dalian; these offer opportunities in SME banking. Additionally, major ports such as Qingdao, Dalian, Tianjin and Ningbo, also offer great potential for maritime and trade finance.

- High concentrations of enterprise, foreign investment and high per capita GDP make cities like Suzhou and Hangzhou attractive for wealth management and consumer business; while Dongguan, Foshan, Tianjin and Chengdu are noted for having high household savings rates.

- Financial institutions are not confined to Beijing, Shanghai and Shenzhen. Tianjin won the bid to establish China's first over-the-counter (OTC) board to trade in shares of non-listed companies, and has plans to become a regional financial centre, which are strongly supported by the national government. Dalian and Zhengzhou also boast commodity exchanges.

- Cities throughout China, including Suzhou, Hangzhou, Chengdu, Dongguan, Wuhan and Tianjin are focusing on promoting innovative growth industries, and Wenzhou is also noted for its dominant private sector - providing opportunities for private equity and venture capital.

fee income, while the 'Big Four' are all significantly ahead of the largest Chinese accountancy firms.

The number of Chinese companies needing the expert advice the UK has to offer will increase throughout 2010, and legal, accountancy and professional services firms are set to benefit from this. This advice is needed both within China and to meet the ambitions of many Chinese companies to 'go global'. UK expertise can provide the services these companies need in order to expand overseas, and meet their needs for capital. London, as the world's leading international financial centre, can help Chinese companies expand into the UK, through investing, listing and M&A. The UK can also provide the expertise to facilitate Chinese investments throughout Europe and the world.

Going regional

Many UK financial services firms base their China operations in the 'first tier' cities of Beijing, Shanghai, Guangzhou and Shenzhen, but opportunities are abundant throughout the country, where there are roles working with Chinese as well as international clients. The development of China's regional cities, and the opportunities this affords for UK business is something in which CBBC has taken a keen interest [see 'financial hotspots' above]. As these cities grow, they will require more financial services and more sophisticated products and institutions; some will develop into regional financial hubs, and that will bring with it vast potential in financial and professional services. CBBC is helping UK companies seize these opportunities and more.

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CBBC's work in the financial services sector

CBBC's extensive government and industry network, together with our diverse range of practical services are all dedicated to helping British companies do more, and better, business in China. We provide CBBC members with access to a wide range of Chinese companies and officials visiting the UK; and in China through visits, events and bespoke work we help members meet with business and government.

2010 will be another busy year for CBBC in financial and professional services, and it has begun already with our Chairman Sir David Brewer speaking at the Asian Financial Forum in Hong Kong in January. There will be financial services events and activities throughout the year in both countries. In the UK we will be greeting delegations, hosting seminars, and organising networking events, including the annual CBBC/IFSL financial services lunch. In China, we will be involved in a multitude of activities across the country throughout the course of the year, we particularly look forward to an active Shanghai Expo, and in September there will be a series of financial, legal and business services events, as well as a visit by the Lord Mayor of the City of London.

2010 will be full of activities across Britain and China, if you would like to learn more, please contact Duncan Levesley (duncan.levesley@cbbc.org).

Renminbi goes global

The first international trade transactions in the Chinese currency have taken place, in a carefully controlled pilot project. This is a significant move in the trend towards trade liberalisation and the removal of currency restrictions, writes Chris Lewis.

In July 2009, the People's Bank of China released the final details of a pilot scheme that allows trade between the Chinese mainland and Hong Kong, Macao and certain countries of the Association of Southeast Asian Nations (ASEAN) to be settled in renminbi.

HSBC handled the first cross-border renminbi trade transaction in Hong Kong under the pilot very shortly after the scheme went live, and HSBC subsequently completed its first renminbi denominated trade transactions in all the ASEAN nations in which it operates. While the initial pilot is relatively modest in scope, there are expectations that it will be extended in due course to include other countries. In the short term it seems probable that the initiative will replace the use of the US dollar and the euro in some existing trade transactions. However, in the medium to long term there are hopes that it will lead to significant new trade activity as new participants are attracted by the advantages of renminbi settlement, principally the reduction of foreign exchange risk.

Starting the process

The mainland Chinese government's preliminary announcement in late 2008 that it would be permitting the limited use of renminbi as a trade currency between China and Hong Kong/Macao was not entirely unexpected. A limited range of retail renminbi transactions have been possible for some time in Hong Kong and these have now been extended as part of the pilot. In addition to the existing seven designated merchants engaged in personal tourism or consumer services, all companies in Hong Kong that are engaged in imports or exports with designated mainland enterprises can open renminbi accounts for the purpose of settling

cross-border renminbi trade.

A further announcement in April 2009 revealed that the pilot project would operate between five designated mainland cities (Shanghai, and four cities in Guangdong – Guangzhou, Shenzhen, Zhuhai and Dongguan) and Hong Kong/Macao. The final detailed announcement of the pilot scheme by the People's Bank of China (PBOC) in early July actually extended this in that it stated that the pilot would also allow these cities to settle trade with countries of the Association of Southeast Asian Nations (ASEAN) in renminbi. (It was originally anticipated that this would not happen until a later phase of the pilot.)

There was a swift reaction by the market to the final detailed announcement of the pilot, which was closely followed by the first ever cross-border renminbi trade transaction in Hong Kong by an international bank. This was conducted by HSBC in cooperation with its strategic partner Bank of Communications (BoCom). Also in cooperation with BoCom, HSBC subsequently completed its first renminbi denominated trade transactions across all its ASEAN sites, which include Brunei, Indonesia, Malaysia, Singapore, Thailand, the Philippines and Vietnam.

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Possible outcomes

The recommendation of corporate candidates for the pilot scheme is handled by various provincial agencies, and is subject to joint review by the People's Bank of China, the Ministry of Finance, the Ministry of Commerce, the General Administration of Customs, the State Administration of Taxation, and the China Banking Regulatory Commission. The head office of the People's Bank of China has indicated its intention is to further expand the number of participating companies in the future, but in the pilot stage it appears that the number will be limited to around 400.

Although the initial scheme is fairly modest, it is nevertheless a significant and very welcome step. While both Hong Kong and Macao are special administrative regions of China, both have their own currencies, which are also both pegged to the US dollar – albeit indirectly in the case of the Macao pataca. These linkages will afford all participants an indication of the likely response if the scheme is expanded to include “direct” dollar trade between mainland companies and trading partners in countries outside the initial pilot.

As with any scheme that potentially internationalises the renminbi, the PBOC will be keen to ensure the process is orderly. In the initial pilot, settlement of trade transactions in China will take place either through Bank of China (Hong Kong), Bank of China (Macao) or mainland correspondent banks via accounts held by overseas banks in renminbi.

Related initiative

The pilot scheme to allow the renminbi to be used as a trade settlement currency is part of a broader context of currency and trade deals that China has been agreeing with major trading partners since December 2008. By the end of the first quarter of 2009, China had agreed currency swap deals in various formats with Malaysia, South Korea, Hong Kong, Belarus, Indonesia and Argentina, worth some US\$100bn.

The motivation behind these agreements varies. Occasionally the aim is simply to promote trade by reducing frictional costs and risks for trade participants. In others, the objective is for the renminbi to provide support for the currency of an important trading partner.

A more recent discussion in May 2009 between Brazilian and Chinese leaders Lula da Silva and Hu Jintao intimates an alternative approach. Rather than an outright swap for an agreed rate and size, the notion is simply for Brazil to pay for Chinese goods with Brazilian real and China to pay for Brazilian goods with renminbi.

Immediate outcomes

These currency swap initiatives and the pilot for Hong Kong/Macao have one key feature in common; they will allow the further internationalisation of the renminbi, but in an order-

ly manner. With most of the former, any currency exchanges are defined in advance and typically involve another sovereign government as the counterparty. With the Hong Kong/Macao pilot scheme, the PBOC will closely monitor the activity of participating banks on the mainland, while the Hong Kong Monetary Authority will fulfill the same role for banks in Hong Kong and the Monetary Authority of Macao for those in Macao.

In the short term, this conservative approach may result in a fairly modest effect on trade flows. The mainland Chinese government is facilitating the pilot programme and has emphasised that the currency enterprises use to settle trade is “a voluntary act by both sides of the trading”. However, companies that have the need and can see the potential benefits will be willing to settle trade in renminbi.

These benefits could drive a significant, albeit small-scale, currency switch as importers and exporters come to appreciate the potential advantages for their businesses. Nevertheless some mainland companies may have to take a fairly cautious approach, as some of their customers may insist on continuing to be billed in dollars or euros. While their suppliers may accept being paid in renminbi, this will have little effect on its wider adoption if they prefer not to hold renminbi and always hedge or translate back into their domestic currency. The adoption of renminbi for trade settlement by importers and exporters will obviously also depend on factors such as whether they need to purchase or borrow in renminbi or if they are interested in investing in renminbi-denominated bonds.

Even where trading partners do adopt the renminbi, this is unlikely to drive a significant expansion in total trade with China in the early stages. In most cases, it will be a case of renminbi being substituted for transactions currently being executed in dollars or (to a lesser extent, euros). In the case of trade with Hong Kong and Macao there is an obvious logic to this. Both are close to China in terms of geography and business ties, so using renminbi as their trade currency when transacting trade with China is entirely reasonable.

The implications for Hong Kong as a trade centre are also interesting. Companies both within and beyond Asia (especially in those Latin American countries with which China has signed swap agreements) may be encouraged by the pilot scheme to establish entities in Hong Kong to execute trade business in renminbi. Ultimately they may use Hong Kong as a hub from which to conduct trade beyond the special administrative region.

Further growth

While the short-term effects of the renminbi trade pilot scheme seem likely to be relatively low key, the medium- to long-term picture is a different matter. If there is further extension of

the pilot, it is likely that domestically focused Chinese companies will be inclined to rethink their business strategy. They may previously have been deterred from international trade by the prospect of having to manage dollar or euro currency risk, but will be more inclined to expand into this area if they can settle or hedge easily in their domestic currency.

While by no means a perfect parallel, the effect of the introduction of the euro on trade gives some indication of what may happen to trade flows in the mid to long term if the renminbi becomes more widely adopted as a trade currency. The comparison is imperfect, as the new entrants to cross-border trade in Europe were in many cases attracted by the lower frictional costs of trading with partners within the Eurozone. Nevertheless, there is empirical evidence (from the European Investment Bank) to suggest that the availability of the euro as a trade currency has also had a significant influence in boosting trade flows between Eurozone and non-Eurozone countries.

While the US dollar has a long pedigree as the currency of trade, the sheer volume of non-US-related China trade now flowing makes the renminbi an attractive alternative. At present, the European Union is still comfortably China's largest bilateral trading partner, with the US second. However, China's trade with other nations – particularly the other BRIC countries (Brazil, Russia and India) – has grown phenomenally in recent years. (For example, in April 2009, China's trade with Brazil topped US\$3bn; the mainland has now overtaken the US as Brazil's primary trading partner, upsetting a status quo that had prevailed since the 1930s.) Therefore, from the perspective of trade between Chinese companies and their customers and suppliers outside the US, trading directly in renminbi (as opposed to using the dollar as an intermediary currency) makes increasing sense.

If the renminbi continues to become more accessible as a trade currency, further positive considerations kick in. Given the robust state of China's economy when compared with the current condition of other major trade nations (such as the US) it seems reasonable to assume that the renminbi would be similarly robust as a currency. If that assumption proves valid, a growing number of China's trading partners would be content to hold renminbi as an appreciating, strong currency, rather than always hedging out.

At present, the huge liquidity of dollar spot and derivative markets make hedging reasonably cost-efficient, but there is still some frictional cost to using it as an intermediary currency. Assuming the availability of liquid renminbi hedging and trade finance instruments (see “From the Bank Side” below) some non-US suppliers to Chinese companies may see further potential in adopting it for trade. Switching from billing their Chinese customers in dollars to billing them in renmin-

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bi may offer the opportunity to expand margins, while also reducing risks and hedging costs.

From the bank side

While the greater adoption of renminbi would benefit traders, a critical factor will be the pricing and availability of suitable bank products. This in turn will be heavily dependent on the efficiency of the methods available to banks to hedge and raise funds in renminbi. On this point there has been some talk of allowing China-based subsidiaries of Hong Kong banks to raise renminbi funds in Hong Kong. (HSBC has just completed such a fundraising exercise in Hong Kong and it is expected that other banks will shortly follow suit.) While there is a non-deliverable forwards market in renminbi, growth and usage of other renminbi derivatives has been limited.

If there is insufficient liquidity available in the interbank derivatives market for offsetting renminbi risk, pricing and availability to importers and exporters will be impacted and demand for renminbi-denominated trade reduced. The key is how liquidity can be facilitated and extended without giving rise to unwanted speculative activity.

There are certainly signs that the Chinese authorities are already putting the appropriate derivatives infrastructure in place. For example, in March 2009 the PBOC approved the consolidation of various derivatives agreements into one uniform master agreement.

Positive moves

It is clear that greater levels of renminbi-denominated trade could boost global trade in the mid to long term. While it may be premature to predict a significant decline in dollar-denominated trade, it is certainly safe to assume that many trade participants will see the recent moves by the Chinese government and the PBOC as highly positive.

The key will be at what point new entrants take the plunge into overseas markets, or existing participants ramp up their activity in response to the renminbi opportunity. Predicting this tipping point with any degree of accuracy is impossible, but it is obvious that the range, availability and pricing of renminbi trade finance and hedging provided by banks will have a huge influence on its timing.

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