CHINA SPECIAL REPORT

Tapping into the renminbi opportunity

Capital, trade and people flows

Westpac Institutional Bank


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Executive summary

The global financial landscape is changing. According to the International Monetary Fund, China will take over from the United States and become the world's leading economy this year[1]. There is no question that China's economic size, diversified trade structure and high growth mean that the Chinese renminbi has the potential to become one of the world's most widely used currencies.

The Beijing leadership has made it clear that its ultimate goal is to become a high income economy by 2030. It recognises that establishing Shanghai as a first tier international financial centre and transforming the renminbi as an international vehicle currency, on par with the US dollar, are complementary objectives along this path. Reaching these aspirational goals will require the liberalisation of Chinese financial markets, more open cross border capital flows and exchange rate flexibility. Each of these matters are inextricably linked to the evolution of China's domestic policy and to each other. They are complementary to the parallel desire to rebalance the economy from its reliance on exports, investments and manufacturing, towards a broader-based consumer model, that prioritises innovation led growth in services and rewards savers far better than has been the case hitherto.

This Special Report looks at some of the key issues surrounding the liberalisation process against a backdrop of significant change in China.

The Westpac position on the process of liberalisation

The journey towards liberalisation is well under way through initiatives such as the establishment of offshore renminbi hubs, onshore financial market reform and the push towards greater renminbi liberalisation in mainland China.

Indeed, progress is such that by 2020, Westpac expects to see the following:

1. Opening of the capital account
2. Liberalisation of interest rates
3. Convergence of the onshore (CNY) and offshore (CNH) markets
4. Renminbi on an even footing with other global currencies
5. Significant progress towards establishing Shanghai as an international financial centre
6. Renminbi as an international reserve currency, with Chinese sovereign bonds representing a significant part of global foreign reserves

Australia is now at a positive tipping point in its relationship with China, as the number of touch points broadens away from the traditional avenues to reach every element of its economy. As Chinese liberalisation continues, Australian businesses across Asia, New Zealand and Australia will benefit from increasing opportunities, the transacting of which will become simpler and easier. Westpac is building both onshore and offshore products and services to facilitate this need.

The benefits of liberalisation

The benefits to Australian importers and exporters of invoicing and settling their trades in renminbi should not be underestimated. As long as the US dollar remains the trade currency of choice, particularly for commodities, many transactions will continue to require a three way conversion, from renminbi to US dollars to Australian dollars with a loss of basis points at each conversion point. Direct conversion will create savings. For exporters with a renminbi-denominated cost base, receiving payment in renminbi will become cheaper and easier, and the ability to negotiate discounts and better settlement terms will reduce operating costs. And as the Chinese economy continues to open, Australian savers will benefit from direct access to Chinese asset markets, and Australia's funds management industry will benefit from the ability to service more Chinese savers.

For China, the effects will be considerably greater, as the Chinese are more restricted in their current behaviour, and will thus feel the deregulation more keenly. In addition to the benefits of more flexible and easier trade, as capital flows more freely between the two economies, Chinese investors may well emerge as major providers of capital to Australian business. China's foreign assets are made up of 70% foreign exchange reserves, whereas by 2030, Westpac expects this to decline to 25%, with foreign direct investment and banking assets making up a much larger proportion. In due course, private portfolio assets will also increase.

1. www.imf.org/weo

Westpac Institutional Bank

Impact for Australian companies

Australian corporates are playing a waiting game when it comes to dealing in renminbi as they are unsure of what the tangible benefits of a switch to renminbi will be.

Benefits ranging from more favourable pricing, the ability to be more flexible with their Chinese trading partners and improved customer relationships should lead to better access to new opportunities. And for Chinese companies, reduced foreign exchange risk, improved trade terms and benefits from appreciation and depreciation should add to their competiveness and strengthen their relationships with their Australian counterparts. According to Robert Rennie, Westpac's Global Head of Currency and Commodities Strategy, it is clear from the questions he is frequently asked about opportunities arising from renminbi pricing, that many companies have not yet explored the potential benefits and that parties on both sides of the equation still need to embrace the change.

Evidence from a recent survey conducted by the Australian National University suggests that both Australian and Chinese corporates are waiting for the other to initiate[2]. Although Andrew Tait, Westpac's National Head of Trade for Commercial Banking says that transactions between the Australian Dollar and the offshore Chinese currency, known as the CNH, have grown 248% in the year to February 2014[3]. This is a reflection of both the low starting point and a genuine uplift in real demand from customers. He suggests that negotiated discounts can be in the order of 2-3% for companies prepared to invoice and settle in renminbi, which is roughly the rate of average annualised renminbi appreciation against the US Dollar that has been observed since the currency de-pegging in 2005.

The end game – China as a high income economy in 2030

Ultimately, the liberalisation of the renminbi is just one step, albeit a crucial one, towards the real end game for China to achieve high income status by 2030. Other critical steps including interest rate and capital account liberalisation will follow suit. As the Chinese economy integrates into global financial markets, fewer restrictions on capital flows will allow the Chinese to more easily acquire assets in other countries and permit unconstrained access to Chinese domestic asset markets for overseas investors, such as Australians. The inevitable result will be higher overall volumes of capital flows, and a convergence between the size of China's dominant real economic footprint and its under-developed financial one.

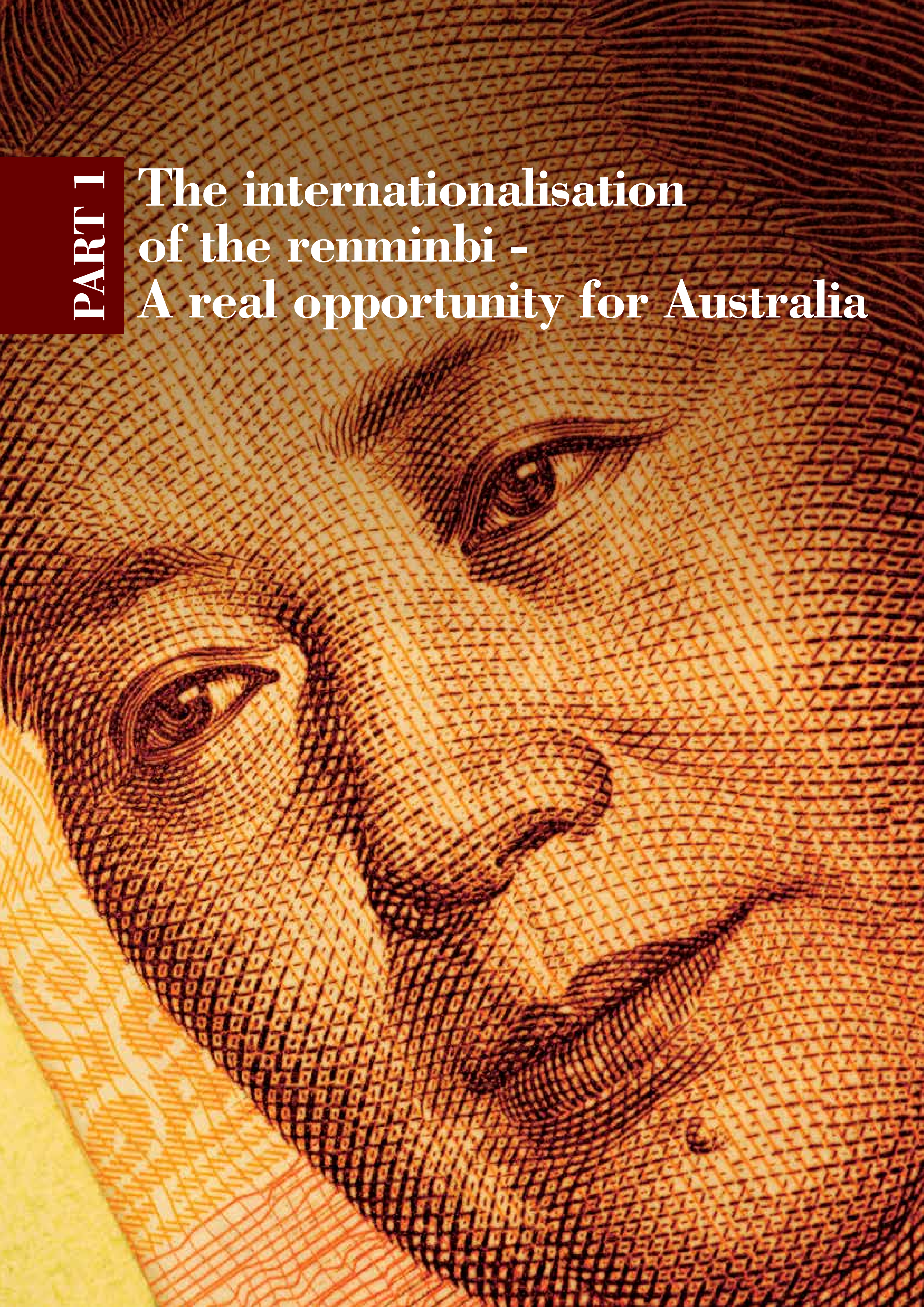
And with its close ties with China growing stronger, as well as the establishment of a Sydney settlement hub for renminbi trade, Australia is well positioned to realise benefits from the increasing flow of trade, capital and people as we embrace the Asian century.

2. Kathleen Walsh (2014) *"RMB Trade Invoicing: benefits, impediments and tipping points"* Australian National University. Available at www.treasury.gov.au

3. SWIFT RMB Tracker March 2014.

PART 1

The internationalisation of the renminbi - A real opportunity for Australia



"The outbreak of the current crisis [GFC] and its spill over in the world have confronted us with a long-existing but still unanswered question - what kind of international reserve currency do we need to secure global financial stability and facilitate world economic growth?"

Zhou Xiaochuan,
Governor, People's Bank of China,
March 2009[4]

What does liberalisation mean for China?

The internationalisation of the renminbi is an essential catalyst for China to take its place among the world's truly 'systemic' economies and play an influential role in global financial markets that is equivalent to its real economic scale. In becoming a high income economy by 2030, the Beijing leadership's ultimate goal is to position its financial capital Shanghai as a dominant international financial centre, with the renminbi on par with the US dollar, in all facets of international exchange. While it is clear that China is taking considered and deliberate steps towards these objectives, the pathway and timing of this is still unclear. Many, including Westpac, project that deregulatory steps will have taken place across the full gamut of relevant domestic and international financial matters by 2020.

The internationalisation of the renminbi is a natural step along the way to the long term goal of achieving high income status for the Chinese people by 2030. Expanded use of the renminbi and a likely parallel, albeit carefully sequenced opening of the capital account, will integrate China as a key player in global capital markets and have profound economic implications for its major trading partners such as Australia. As Philip Lowe, Deputy Governor of the Reserve Bank of Australia (RBA) has argued, increased utilisation of the renminbi to settle trade, raise capital and invest portfolio-based savings could create a significant shift in the international financial landscape. It could ultimately prove to be as transformative for global capital markets as China's development of an export-driven manufacturing sector was for the global trading system.[5] To add to those remarks that it will be flows intermediated by the banking system (loans, deposits, trade finance and derivative based hedging) that will dominate the next leg of deregulation, with unrestricted offshore flows from Chinese investors coming later in the piece.

By liberalising the use of the renminbi offshore and strengthening domestic financial markets, China aims to reduce the dependence of its sovereign wealth, and its private entities on the US dollar, which undeniably remains the global reserve currency and the currency most used in third-party transactions. Encouraging international trade partners to transact in renminbi will be part of the journey for China, as will be increasing the level of renminbi denominated foreign assets and liabilities.

There has been a steady flow of activity in financial liberalisation in China since the mid 2000's. Greater flexibility in setting deposit and particularly lending rates has been introduced, although they are not yet fully free. Exchange rate flexibility has been increased progressively after the peg to the US dollar was abandoned in 2005; foreign exchange reserve accumulation has levelled out; the supply of renminbi now available outside the Mainland has increased rapidly as part of the trade settlement program, the centrepiece of the internationalisation initiative. Moreover, the Qualified Foreign Institutional Investor (QFII) program, the Qualified Domestic Institutional Investor (QDII) program and a new renminbi QFII program, alongside the new Hong Kong-Shanghai Connect initiative, have been revamped or instituted; and outward flows of direct investment have continued to enjoy policy sponsorship.[6]

In order to provide investable securities for offshore holders of renminbi, China has allowed the development of renminbi clearing and settlement to facilitate offshore bond issuance. Hong Kong initiated the process with its "dim sum" bond market, followed by expansion in Singapore and London with the expectation that Sydney will follow in the near future. Dim sum debt issuance in the first quarter of 2014 was approximately RMB 125 billion.[7]

As indicated in the quote above by Zhou Xiaochuan, the Governor of the People's Bank of China (PBOC) and a major figure in Chinese financial liberalisation, the 2008-09 global financial crisis (GFC) was an accelerant for renminbi internationalisation. The seizure of the US-dollar based banking system effectively halted global trade, severely impacting Chinese export industries. Despite the central bank holding almost US$2 trillion in foreign exchange reserves when Lehman Bros went down (a number that has increased to approximately $US4 trillion today), tens of thousands of Chinese firms found themselves temporarily unable to procure US dollars for trade settlement. This period highlighted the dependence of the global trade system on the US dollar, with emerging markets in particular, feeling that they needed more control over such matters.[8]

4. Zhou Xiaochuan (2009)"Reform the International Monetary System" The People's Bank of China available at http://www.pbc.gov.cn/publish/english/956/2009/20091229104425550619706/20091229104425550619706_.html

5. Philip Lowe (2014) "Some Implications of the Internationalisation of the Renminbi", Reserve Bank of Australia available from www.rba.gov.au

6. Huw McKay, (2013) "Tokyo's ultimately failed bid for first tier international financial centre status: why did it fall short and what are the lessons for Shanghai?", in W.T. Woo, Y. Pan, J. Sachs and J. Qian Financial Systems at the Crossroads: Lessons for China, World Scientific Publishing: Singapore.

7. Dim Sum bond issuance, http://www.reuters.com/article/2014/04/08/markets-offshore-dimsum-idUSL4N0MT1ZH20140408

8. While data on trade finance is difficult to procure due to financial reporting norms tending to subsume it into broader lending categories, some official studies put 90% of the slowdown in global trade during the GFC down to loss of demand and 10% to finance issues. These numbers are very approximate and should be interpreted with caution, but the relative magnitudes are instructive.

China accordingly decided to be better prepared should such an event occur again. The first step was to strengthen a phased program that allowed renminbi trade settlement with a range of international partners (mostly in other emerging markets) and selected cities at home, mostly near the coast. The process was aided by the PBOC extending renminbi swap lines to foreign monetary authorities in these jurisdictions. Financial markets in these economies tended to be characterised by relatively domineering central banks, making the experimental process as "controllable" as possible.

The element of control was crucial, given that just as the GFC highlighted the US dollar's dominance, it also highlighted (as did the Asian Crisis of the late 1990s) that a restricted capital account was the best defence against the propagation of international financial stresses.

From manufacturing powerhouse to a consumer mega market

The internationalisation programme links with other policy objectives as Beijing seeks to rebalance its economy from the current investment-manufacturing-exports complex towards a broader-based consumer economy, where services play a greater role. This reform objective needs to be supported by a financial system that channels capital toward the most efficient users, while rebalancing income distribution. In this regard, internationalisation of the currency dovetails with moves to reform the domestic banking market, in particular the gradual liberalisation of bank deposit rates.

For China's financial system and its monetary policy to converge with advanced country norms, market determined interest rate and capital account liberalisation will have to complement the already more flexible exchange rate. Fewer restrictions on capital flows will allow Chinese residents to more easily acquire assets in other countries and permit unconstrained access to Chinese domestic asset markets for overseas investors including Australians. The result will be increased financial integration between China and the global economy with higher overall volumes of international capital movements.

The benefits of liberalisation for China will ultimately be reduced exchange rate risk, lower hedging and transactional costs, greater liquidity, more efficient financial markets and more transparent governance structures. However, by relinquishing the kind of direct monetary control they have traditionally held, China's authorities will need to accept that fiscal policy will become a less effective lever as the "animal spirits" in the private economy will have an increased influence on the business cycle.

The 'shadow banking sector' is paradoxically a bi-product of both financial liberalisation (the effort to diversify the type of intermediary in the system and encourage private financial market development) and its relatively slow pace to date. For example, the rapid increase in wealth management products is a direct response to the low returns available to Chinese savers on regulated deposit rates. Also, with a legislative cap on loan-to-deposit ratios, and with high required reserve ratios (averaging 19.5%), there is a clear profit motive for banks to operate "off-balance sheet" to circumvent the regulations. The shadow banking example highlights the "unintended consequences" principle of public policy.

"Given the likely future scale of China's economic and financial footprint, it seems reasonable to venture that the renminbi has an excellent chance to become a genuine international vehicle currency at some point, as it will be the world's largest economy for at least the next two generations."

Huw McKay, remarks at the *International Symposium of Financial Market Reform: international experience and China's road*, Shanghai Jiaotong University, September, 2013.

Benefits and challenges for Australia - The future is bright

China accounts for one third of Australia's exports and is its largest trading partner with bilateral trade worth about $150 billion per year. There is no doubt that a currency liberalisation plan which, in the first instance is intended to boost trade settlement in renminbi, will have a disproportionate impact on Australia's economy bringing with it both opportunity and challenge.

Until the early 1980s Australia was a relatively closed and highly regulated economy. It made a conscious choice to adopt a flexible currency, liberalise its financial sector and open up to foreign competition, in finance and in traditional goods and services trade. Chinese policymakers are likely to have considered the Australian experience which has seen the integration of Australia's financial system into global markets, leading to disciplined macroeconomic policy, more diversified investment portfolios for Australian investors, and the development of sophisticated tools to hedge risk. While China's path to liberalisation will deviate at times from Australia's (notably, Australia chose to liberalise deposit rates ahead of lending rates; China has chosen the opposite path), it holds with it a similar promise, as the ultimate objectives are essentially the same.

China's progressive capital account liberalisation is likely to see Chinese investors emerge as significant direct providers of capital within the Australian economy. Conversely, Australian savers will benefit from having direct access to Chinese asset markets, and so the potential to diversify their portfolios. Moreover, Chinese financial liberalisation should provide opportunities for Australia's highly developed funds management industry to provide services to Chinese savers. For Australian importers the growth of renminbi trade settlement will lower transaction costs and allow for more efficient hedging of trade finance and currency exposures.

The implications for Australia – Beyond goods & degrees to financial services

Trade links between Australia and China are already strong and the financial links are increasing. The expected completion of a Free Trade Agreement between China and Australia will further strengthen economic ties. In addition, Australia has leading edge technology in agriculture, food, water, abatement of air pollution, health services and education; all of which are needed by the Chinese. Trade in these areas should increase.

As the vast pool of domestic savings in China starts to flow more freely into other capital markets, including Australia's, it will provide a significant boost to liquidity, new sources of capital and a massive new investor base. In fact, some estimate that China could overtake the US and Britain as the largest source of foreign direct investment in Australia over the next two decades. As capital flows between the two countries increase, there will inevitably be increased demand for hedging products and other financial instruments. The opportunities are manifold, from managing funds for foreign investors and creating renminbi-denominated wealth management, insurance and other financial products for sale to Chinese and Asian investors, to developing distribution channels made possible by the expected free trade agreement.

The transition to a deeper financial and trading relationship with China is not without its risks

Australia's economy is closely linked with China's and will be more exposed to any future economic and financial shocks emanating from China's transition. Such effects would be initially transmitted through increased volatility in the price of, and demand for commodities and energy, but as our relationship broadens, arguably few areas of our economy would be left untouched. Australia has benefitted from a positive terms-of-trade shock over the last decade, in part due to Chinese demand for ores and energy. That process has the potential to reverse and indeed we have already seen significant correction in some bulk commodity prices as supply and demand move more in line.

Australia's financial system has a dependency on external funding and is vulnerable to a squeeze in overseas liquidity as highlighted in the 2008-09 financial crisis. As Australian entities increase their exposure to renminbi funding sources, questions will likely arise about the reliability of this liquidity, especially if it needs to be refinanced during periods of financial stress.

The RBA has started to build renminbi foreign exchange reserves, arguably with something like this hypothetical circumstance in mind. Additionally, it signed a bilateral currency swap agreement with the PBOC in March 2012. Both of these initiatives should help to deliver greater assurance to market participants that sufficient liquidity will be maintained at all times when dealing in renminbi denominated products.

Change is coming thick and fast

Huw McKay, Westpac's Senior International Economist, argues that China's tightly controlled capital account has artificially restricted China's share of international financial transactions, which are trivial when compared with its slice of the real economy. Today, China accounts for around 16% of world GDP, but its share of private capital flows are a mere fraction of that. But as barriers to capital movement are progressively lifted, this anomaly will be corrected.

The scenario that Westpac sees as most likely, noting the approximate nature of any long term forecasting project, would see China's geographic share of global foreign exchange transactions rise from 0.4% in 2010 to 5% in 2018. Global foreign exchange transactions involving CNY (onshore renminbi) will increase from $US34 billion per day in 2010 to $US262 billion per day in 2018. By 2030, China's geographic share of global foreign exchange turnover will rise to 15%.

The speed of renminbi internationalistion will be led by its increasing adoption as a trade currency. Since December 2013, it has been the world's second most used trade currency. Invoicing and trade settlement denominated in renminbi has been steadily increasing in recent years. According to Westpac research, as of the first quarter of 2014, 18% of China's trade was denominated in renminbi, this is expected to rise to 30% by 2015. However, the mega-scale of cross border flows predicted above must await the accumulation of a wider range and deeper pool of foreign exchange assets held by Chinese abroad and foreigners in China.

> **"When you think about alignment, China is the most aligned with us from an 'Asian Century' perspective. Down through all levels of the value chain, China makes sense for Australia"**

Hugh Killen, Managing Director, Global Head of Foreign Exchange, Westpac

Based on these observations, as well as the establishment of offshore renminbi hubs in strategic financial centres, various onshore financial market reforms and increased avenues for cross border use of renminbi for trade and investment activities, Westpac believes that the following will occur by 2020:

1. *Opening of the capital account*: Banking related transactions (loans, deposits, and derivatives) will flow freely in both directions. While inward institutional portfolio flows will progressively be increased, with outward flows not far behind, outward household portfolio investment will still be subject to material regulation at this stage.

2. *liberalisation of interest rates:* The final frontier regarding interest rate deregulation is to allow the deposit rate to be set by market forces. Lending rates are already largely market determined, but deposits are constrained to be no more than 1.1 times the regulatory ceiling. Complementary reforms of deposit insurance and the legislative loan-to-deposit ceiling are likely pre/co-requisites for deposit rate deregulation.

3. *Convergence between onshore (CNY) and offshore markets (CNH)*: RMB or renminbi will be broadly fungible and the role of offshore renminbi hubs will evolve as capital flows become denominated in CNY.

4. *Renminbi will be on an even footing with other global currencies:* the renminbi cross-border payment clearing system China International Payment System (CIPS) will ensure global renminbi liquidity and will have similar operating hours, risk reduction and liquidity optimisation to currencies such as the US Dollar, Euro and Pound Sterling.

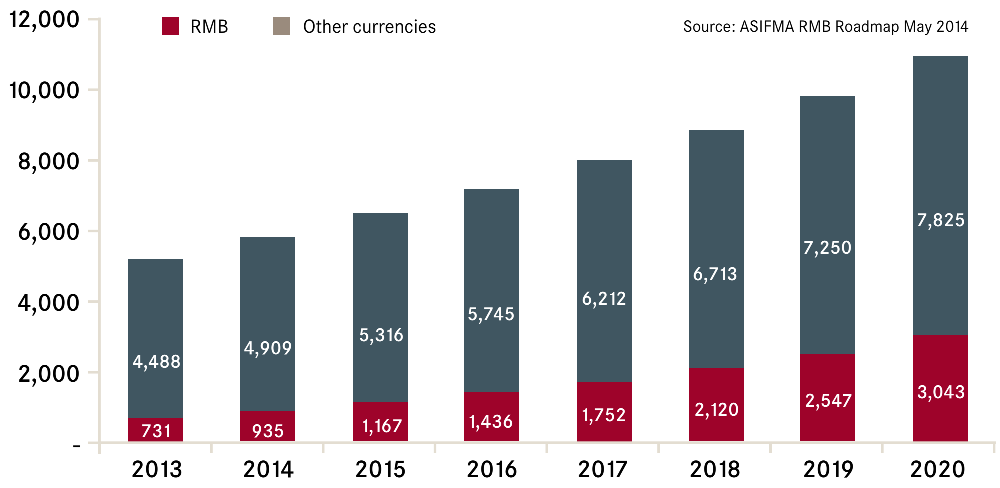
5. *Significant progress towards establishing Shanghai as an international financial centre.*

6. *Renminbi will be an international reserve currency* and Chinese sovereign bonds will constitute a significant part of global foreign reserves.

Trade and investment – Two sides of the liberalisation coin

It is important to understand that the process of liberalisation has two interconnected parts. On the one side the liberalisation of the currency and on the other, the liberalisation of the capital account. This is expected by many observers, including Westpac to occur by 2020, which will allow the relatively free flow of capital in and out of China in all balance of payments categories. The term 'relatively' is used, because of the view that the timeline is nuanced. Deregulatory moves are expected across the gamut of capital account items, with some flows still subject to some restriction by 2020, with private household portfolio flows a likely laggard.

China as a trading nation
Renminbi becoming a global currency – Trade, FX, bonds



Share of China's trade settlement projection in RMB
(US$ bn equivalent)

CNH trading volume trend

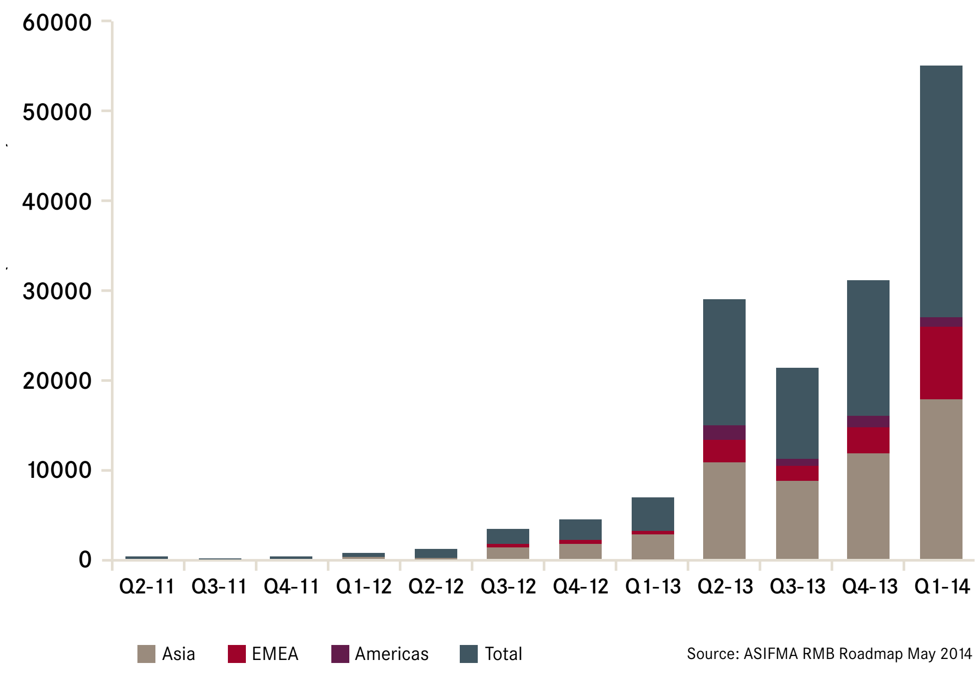


CHART SOURCE: *RMB Internationalisation for Trade & Investments, Westpac*

CHART SOURCE: RMB Internationalisation for Trade & Investments, Westpac

Offshore RMB bonds issuance by home country of issuer

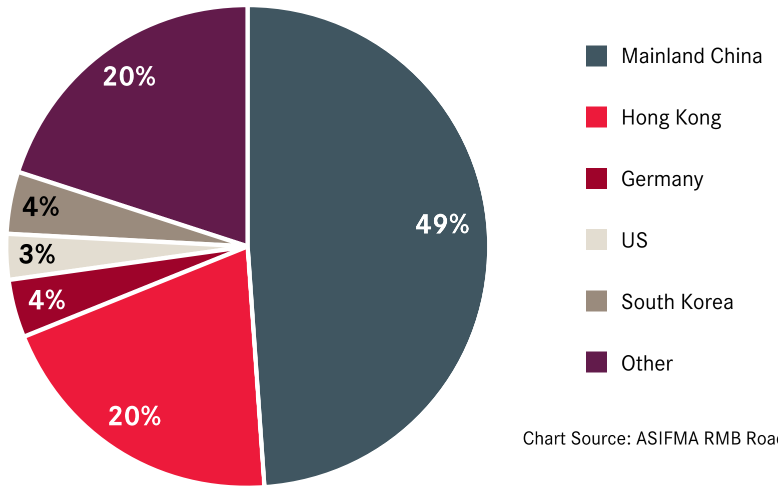


Chart Source: ASIFMA RMB Roadmap May 2014

CHART SOURCE: RMB Internationalisation for Trade & Investments, Westpac

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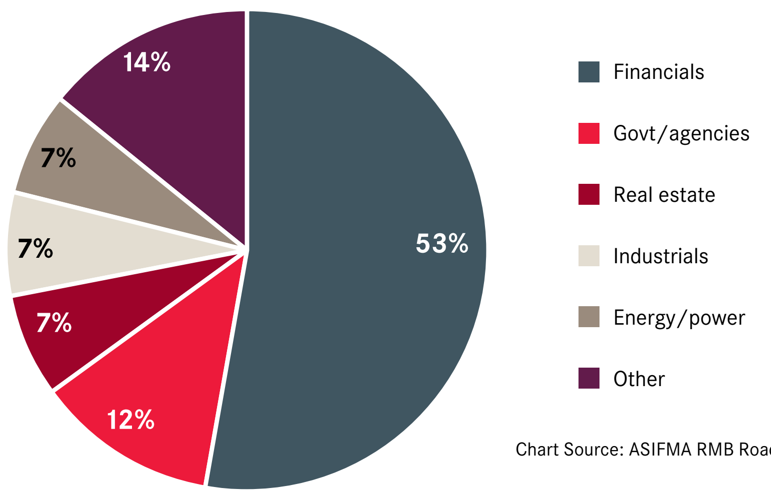


Chart Source: ASIFMA RMB Roadmap May 2014

PART 2

Currency liberalisation - The essential next step for a trading nation

Renminbi trade settlement is growing rapidly, although different sources provide different estimates and there are some signs of a slowing in recent years.

Renminbi becoming a global currency – Trade, FX, bonds

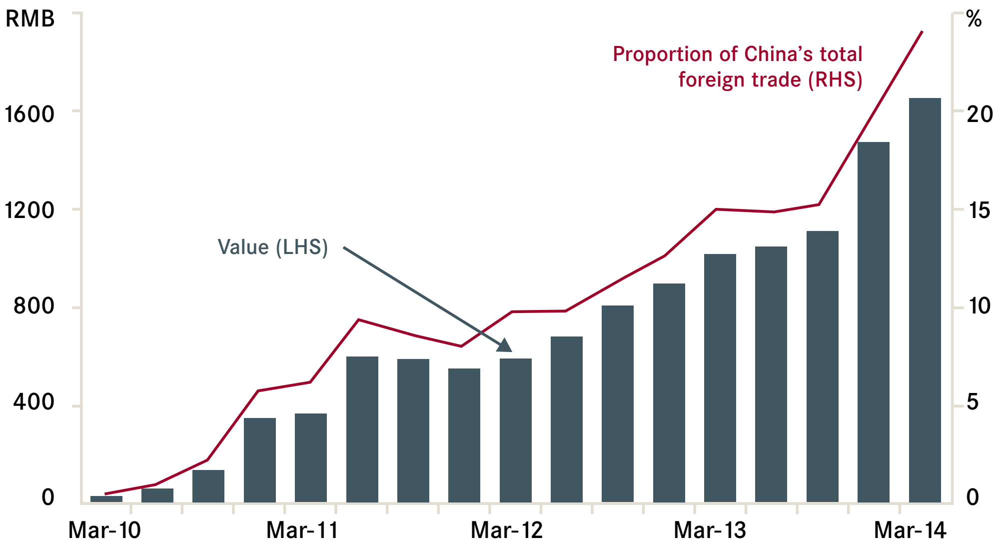
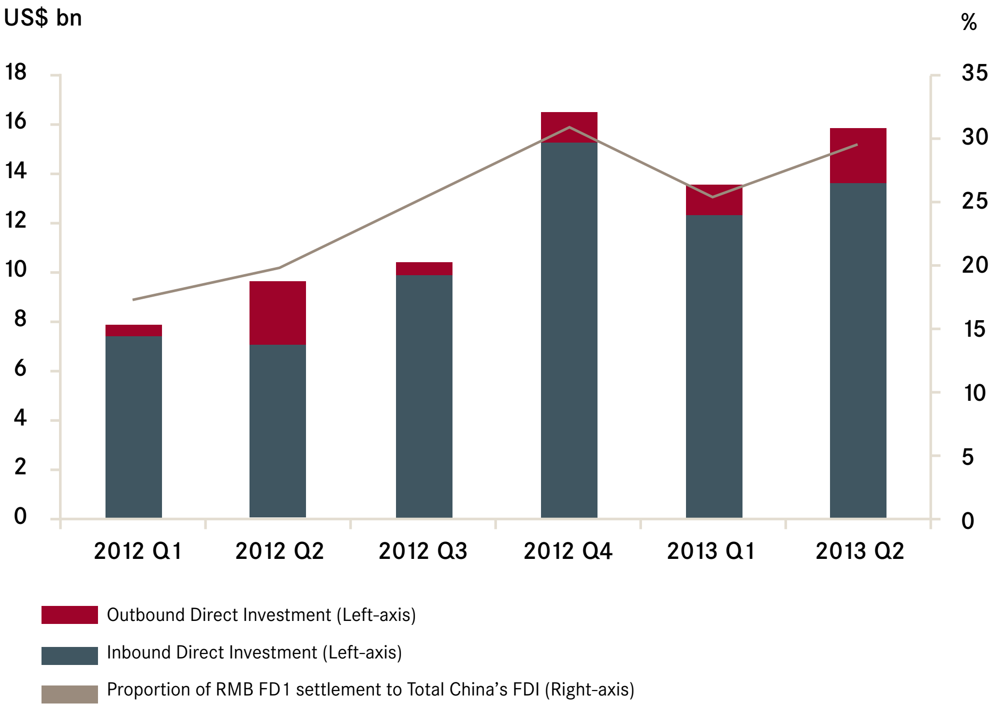


CHART SOURCE: Chart 1, Australian National University, RMB Trade Invoicing, Benefits, Impediments and Tipping Points

Renminbi deposits in Hong Kong have grown rapidly as a result of liberalised trade settlement measures and the extension of renminbi savings account at banks in the territory. In addition, foreign direct investment denominated and settled in renminbi is also growing, although not so dramatically.

Renminbi-denominated and Settled FDI



Sources: People's Bank of China, CEIC, Bloomberg

CHART SOURCE: Page 10, Pathways to Renminbi Internationalisation, Barry Eichengreen, March 2014, from the CIFR roundtable papers

Impact on business

The benefits of efficiency for both importers and exporters are too great to ignore. As long as the US dollar remains the trade currency of choice, particularly for commodities, many transactions will continue to require a three way conversion, from renminbi to US dollars to Australian dollars, with a loss of basis points at each conversion point.

The ability to transact and convert directly will ultimately create savings. For exporters with a renminbi-denominated cost base, receiving payment in renminbi will be cheaper and easier, with the prospect that some of these savings will be passed on to their Australian customers.

Navigating change and guiding business

Despite the advantages offered by direct transactions with the renminbi, years of familiarity dealing with the US dollar are unlikely to be replaced overnight. Many businesses prefer the certainty of the familiar over the promises of the new. Others may not understand that changing to renminbi can be a source of competitive advantage, or that their ability to negotiate discounts and settlement terms may reduce operating costs – with flow-on effects to working capital management.

Andrew Tait, Westpac's National Head of Trade for Commercial Banking, makes the point that AUD-RMB transactions are growing at 248% each year[9], yet many customers are not aware of the specific discounts they may be able to negotiate if they are prepared to invoice and settle in renminbi, and that fear of the change may be holding businesses back. He cites potential discounts in the order of 2-3%.

His experience is reinforced by a recent renminbi invoicing survey of Chinese and Australian enterprises conducted by the Centre for International Finance and Regulation (CIFR)[10] which noted that Chinese corporates have typically added up to 5% to their quotes in foreign currency to hedge against unfavourable exchange rate movements.

The survey found that while there was greater awareness of the ability to settle in renminbi in Australia (98%) compared with China (69%), Australian companies were concerned about the costs of deviating from US dollar contracts and cited the unwillingness of trading partners to settle in renminbi and difficulty in accessing hedging products as major drawbacks.

According to the CIFR invoicing survey, 70% of Australian businesses said that they would increase renminbi settlement if requested by Chinese firms, 52% said Chinese firms needed to accept payment in renminbi, and 46% said that Chinese firms needed greater knowledge of renminbi settlement before they would consider it.

One of the most potent conclusions from a recent Australian National University survey is that both Australian and Chinese corporates appear to be waiting for the other to initiate a change to invoicing in bi-lateral trade. "70% of Australian corporates are waiting for Chinese firms to request renminbi invoicing and 76% of Chinese corporates are waiting for Australians to accept it." The report goes on to note that "Although the Chinese corporates were waiting for the Australian trading partner to request or accept renminbi only 28% expected their trading partner to encourage them to do so. In contrast 49% of Australian firms expected the push to come from China."[11]

Robert Rennie, Westpac's Global Head of Currency Strategy notes that while Australian corporates may be aware that there could be benefits available from renminbi pricing, they are playing a waiting game. "A question I am often asked by Australian corporates is whether there are real benefits from renminbi pricing. The answer I give is, 'Have you asked?"

"Exporters not dealing in renminbi can often lose basis points twice on conversion, not to mention time. And time is money from a working capital perspective."

Bala Swaminathan, General Manager, Westpac International

9. SWIFT RMB Tracker March 2014.

10. Geoff Weir (2014) *"RMB Invoicing and RMB Internationalisation: Opportunities, Outlook and some Research Issues"* Centre for International Finance and Regulation available at www.cifr.edu.au

11. Kathleen Walsh (2014) *"RMB Trade Invoicing: benefits, impediments and tipping points"* Australian National University. Available at www.treasury.gov.au

Benefits of renminbi Pricing for Australian corporates

- Cost and time savings
- Ability to accommodate Chinese companies
- Improved customer relationships with Chinese trading partners

Benefits of renminbi Pricing for Chinese corporates

- Reduced foreign exchange risk
- Benefits from appreciation/depreciation
- Improved trade terms

Case study 1

OVERVIEW: An Australian finished metals products importer had been sourcing product from China in USD.

PROBLEM: Chinese supplier bore costs associated with dealing in USD, which were passed on to the Australian importer.

SOLUTION: Invoice in RMB.

BENEFITS:

- Importer secures a better price (3%) due to the reduction of costs borne by the Chinese supplier.
- Importer secures contracts with other suppliers in China for a variety of finished products by negotiating in RMB.
- Importer was able to negotiate longer trade terms at more competitive rates.

Case study 3

OVERVIEW: An Australian importer/exporter corporate funding its Chinese subsidiary previously had to manage capital via China.

PROBLEM:

- Limited visibility of funds.
- Restrictions in mainland China did not allow for easy repatriation of funds back to Australia.

SOLUTION: The corporate manages the funding from Australia with RMB accounts domiciled in Australia.

BENEFIT: Allows the corporate to control working capital in China through a more seamless approach, as they do for all other currencies.

Case study 2

OVERVIEW: Chinese exporter conducts business transactions with foreign companies in USD.

PROBLEM: Managing export business in USD is more costly for the exporter.

SOLUTION: Invoice in RMB.

BENEFITS:

- Exporter gains access to RMB working capital from VAT.
- Exporter no longer has additional costs for USD financing.
- Exporter can still claim an Export Rebate.

Case study 4

OVERVIEW: Global Treasury of a foreign owned auto company executes and funds FX hedging across various entities around the world. The Australian and NZ subsidiaries currently have Foreign Currency accounts in various currencies (USD, EUR, GBP, JPY, SGD, HKD, NZD).

PROBLEM: The customer was unable to hedge RMB risk due to perceived regulatory limitations.

SOLUTION: The Global Treasury funds both Aust and NZ accounts in foreign currencies including RMB.

BENEFITS:

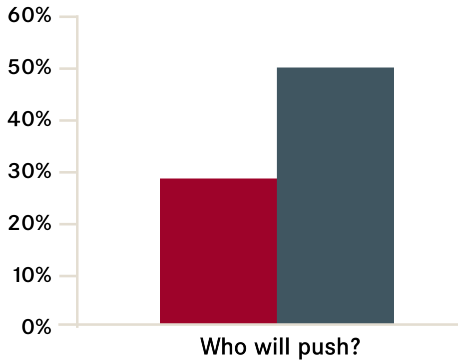
- Liquidity management – able to pool cash and move it cross-border to fund different subsidiarie.
- Ease and convenience – company has visibility of all funds in different currencies and is able to manage accounts payable for all currencies in the same way.

RMB pricing – Who is waiting, who is pushing?

Who is waiting for RMB pricing?

- Australian firms waiting for Chinese firms to request RMB invoicing
- Chinese firms waiting for Australian firms to request RMB invoicing

Who will push for RMB pricing?



- Chinese firms expecting push to come from Australia
- Australian firms expecting push to come from China

Source: Australian National University, RMB Trade Invoicing, Benefits, Impediments and Tipping Points

PART 3

Reaching a tipping point - Westpac supporting growth and renminbi liberalisation

"We have capability in China already and are one of only two Australian banks with a market maker's licence allowing us to trade AUD/CNY directly. We are hard at work making the roads, but we still need to be sure that the cars can run."

Yogan Rasanayakam,
Managing Director, Westpac Partnerships and Alliances

> **"The internationalisation of the renminbi is not just important for China, it's important for companies all over the world. Being able to transact in renminbi opens up new opportunities. It leads to cost savings, better trade relationships and less risk."**

Hugh Killen, Managing Director, Global Head of FX, Westpac.

China is an established global economic power although the country's economic might has not yet been matched by its global financial integration. For Westpac, customers across Asia, New Zealand and Australia are increasingly seeking more renminbi products and services with trends suggesting that growth in renminbi trading has reached a tipping point.

Wendy Wu one of the largest Chinese tourism operators in Australia, is one such company facing this challenge.

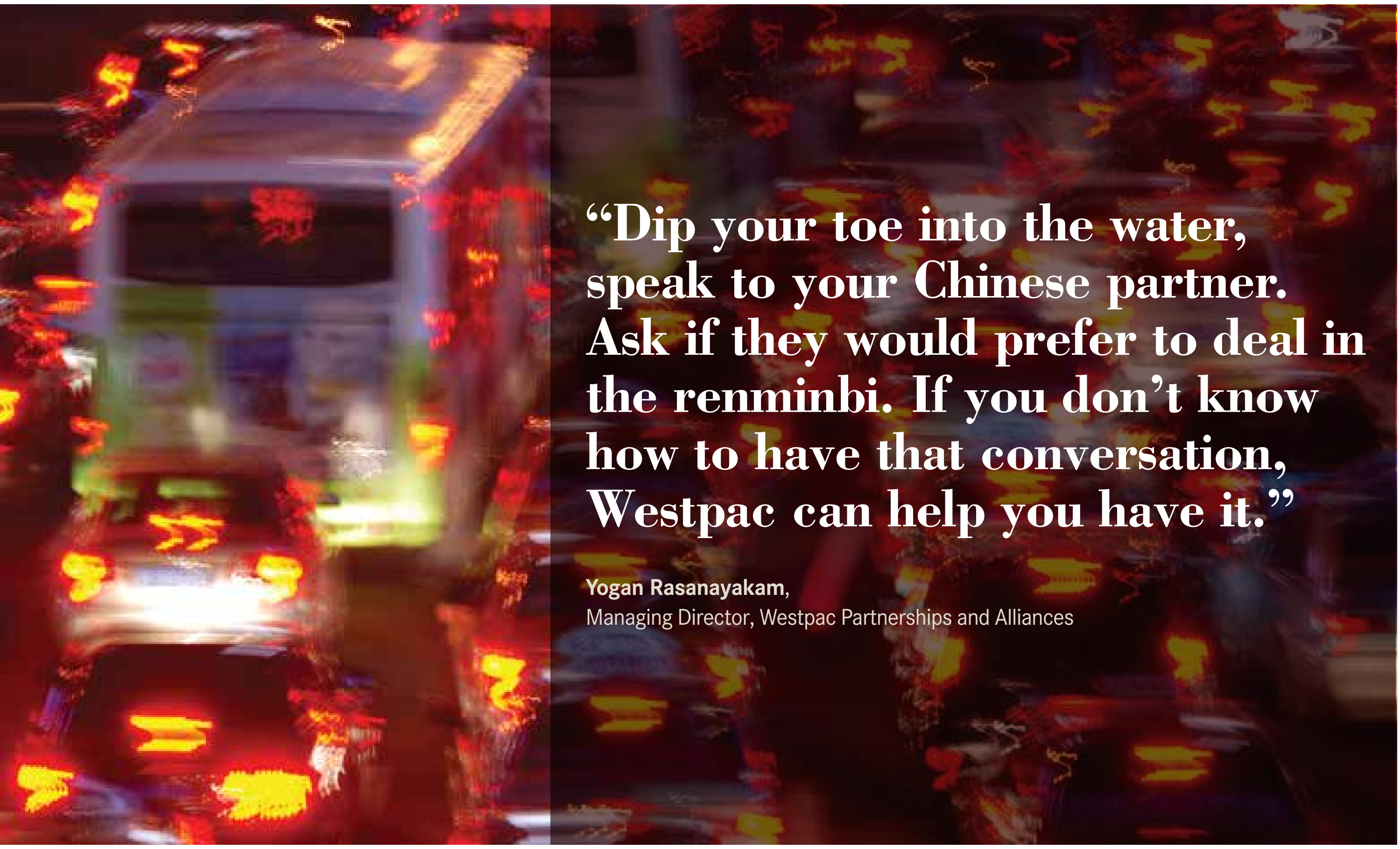
Wendy Wu CEO Alan Alcock is looking forward to eventually having an renminbi account that sits alongside his Australian Dollar account, under his total control.

"To assist my business in China, I'm currently transferring large lumps, that sit in a bank account in Shanghai and we pay out from that as and when needed. I need to be able to hold renminbi here in Australia so I can pay suppliers directly at any given time, purchase currency as and when I need it and when the exchange rate suits me."

In recognition of this demand Westpac is building a comprehensive renminbi proposition onshore and offshore, including through the following avenues:

- Establishment of a renminbi hub in Asia Pacific: Westpac to participate as a foundational bank.
- China derivatives licence: obtained G7 derivatives licence and renminbi bond/repo licence in February and August 2014 respectively.
- AUD/CNY & NZD/CNY market maker licence: one of two Australian banks to obtain approval in mainland China.
- Shanghai Free Trade Zone sub-branch: preliminary approval to set up a sub-branch to officially open by the end of 2014.

Sydney as a settlement hub will increase demand for renminbi from exporters and importers that deal with China. Westpac is supporting its customers as liberalisation takes place. Corporate, institutional and commercial customers in Australia and New Zealand will have access to Westpac's digital platform, Corporate Online allowing them to deposit and save renminbi in trade and investment accounts as well as convert to and from renminbi or make payments in renminbi.



> **"Dip your toe into the water, speak to your Chinese partner. Ask if they would prefer to deal in the renminbi. If you don't know how to have that conversation, Westpac can help you have it."**
>
> **Yogan Rasanayakam,**
> Managing Director, Westpac Partnerships and Alliances

What does this mean for me?

As the renminbi liberalisation unfolds, it is clear that different industries and market segments will require particular forms of currency-related support. The needs of these customer groups are likely to drive across a range of services offered by the financial services sector.

For individuals, this may be as simple as renminbi-denominated products such as dual currency accounts, structured deposits and investment products, accessible through online and digital channels.

For businesses trading with China, there will be a demand for renminbi -denominated trade finance products, as well as a payments/ receivables capability, the ability to transfer funds online, along with the need for timely insights on economic/political developments in China and how it will impact their trade positions in renminbi.

For corporate and institutional players, there is already an expectation that over time a full range of renminbi denominated products will be available from trade and transactional, to debt market products, including bond issuance, syndicated loans and hedging products to manage currency risk.

Given that only 9% of Australian companies currently transact in renminbi, compared with a global average of 22%, there is real scope for growth especially given the majority of small and medium would-be exporters cite China as their market of choice.[12]

12. (July 2014) Renminbi use linked to companies' China trade growth: HSBC research available at http://www.hsbc.com.au/1/2/about/news/14/140723

PART 4

A high income economy in China - The real endgame

China's difficult choices – Three scenarios for liberalisation

The question is less about the final destination of this reform initiative than the pathway that China adopts to get there.

1. **The sequenced route – Domestic first, international later**

Many have stressed the necessity for a robust domestic banking sector in order for liberalisation to succeed. This route recognises this fact by prioritising domestic financial development liberalisation and reform. This choice recognises that Chinese domestic financial markets must be deeper and more developed, corporate governance and the rule of law strengthened before the risks associated with internationalisation should be countenanced. Only once domestic financial reform has reached a critical stage should currency liberalisation be actively pursued.

2. **The accelerated route – Allowing free market forces to drive domestic reform**

   This path acknowledges the logic of the sequenced route, but shows an appreciation for the opportunities presented by greater international engagement, as China rapidly progresses towards middle income status. At some point in the middle income phase of development, the cost-benefit analysis of maintaining the status quo verses accelerating reform reaches a cross-over point, and things can happen quickly. Eventually, the risks associated with reforming are perceived to be less than the risks from not reforming at all. The rhetoric of the current Chinese leadership clearly indicates that many influential thinkers are now of this opinion.

3. **The middle ground**

   In this intermediate scenario, Chinese financial markets are neither thrown open nor kept entirely closed. This option requires a selective loosening of control over capital flows. This could mean using offshore financial centres without controls to allow for liberalisation of the renminbi, and then progressively deepening the links between these offshore centres and domestic financial markets. It would also involve the establishment of ring-fenced onshore financial zones, like the Shanghai Free Trade Zone where currency can be freely accessed and traded.

   Australia's experience of capital account liberalisation and exchange rate flexibility in the 1970s and 1980s is relevant to the choices faced by China[13]. Liquid hedging markets are required to offset the potential financial instability associated with a flexible exchange rate yet by definition these markets are not well developed when the exchange rate is fixed or highly managed.

   It is hard to liberalise when hedging markets are not well developed, but it is difficult for the markets to develop without liberalisation. Market confidence and the ability to guarantee liquidity will be the key to success. In short, there is a Catch-22 which can be difficult to overcome without decisive policy sponsorship.

> "China will liberalise its markets in a way that is unique and different from the way in which every other country in the world has done it."

Bala Swaminathan, General Manager, Westpac International

13. Financial Reform in Australia and China, Reserve Bank of Australia, September 2014

A toe in the reform waters – The Shanghai Free Trade Zone and Qualified Foreign Institutional Investor program

Created in September 2013, the Shanghai Free-Trade Zone, or China Pilot Free-Trade Zone, is the first free trade zone in mainland China. It was established as a testing ground for a number of social and economic reforms. Transactions which are either prohibited or subject to extensive controls within the domestic economy are permitted. Within the zone, funds can be transferred to and from accounts offshore with minimal restrictions.

Other differences between the zone and mainland China include a dispute resolution mechanism more favourable to foreign investment, fewer financial requirements for setting up a company, a simplified procedure for foreign investors to establish a company and lower minimum investment thresholds.

From a foreign exchange perspective, full renminbi convertibility and unrestricted foreign currency exchange will be allowed within the zone and the process of foreign direct investment and capital account management will be simplified.

China has progressively allowed foreign investors access its asset markets. Since 2002, so called Qualified Foreign Institutional Investors have been able to buy renminbi -denominated “A” shares which are listed on China’s mainland stock exchanges. A similar regulated program allows Chinese investors to invest in overseas securities. In September 2014, the Hong Kong and Shanghai trading exchanges were formally linked for the first time allowing investors to deal directly in the shares of each market.

PART 5

Sydney - A major new node in the renminbi orbit

> "The premise of the hub, namely that we can clear payments here, in real time, rather than in Hong Kong, must lead to efficiencies, which will in turn lead to savings for our customers, and they are starting to see that."

Andrew Tait,
Westpac National Head of Trade for Commercial Banking

Sydney is already a major interest rate and currency trading centre and its strong market infrastructure and robust record of corporate governance means it is well positioned to capitalise on an expansion of renminbi-based business. A Sydney renminbi hub will support the growth in flows between Australia, New Zealand and Asia.

In time, Australian entities could conduct a substantial part of their capital raising activity in renminbi, potentially lowering their cost of capital, while the need for hedging services and associated financial products will provide strong opportunities for the financial services sector.

What is a renminbi settlement hub?

A renminbi settlement hub is an offshore financial centre where renminbi-based trading and transactions, including trade settlements, financing, credit transactions, investments and hedging can occur. The establishment of these hubs in strategic offshore centres is a key component of the currency liberalisation process.

From the Chinese perspective, opening of renminbi settlement hubs has enabled the accumulation of offshore renminbi liquidity without the necessity of opening the capital markets completely, thereby maintaining financial stability.

The first global settlement hub was created in Hong Kong in 2003, Taipei was established in 2012 then Singapore in 2013. The first western hub was established in London in 2014 followed by Frankfurt, Paris, Luxemburg, Seoul and Sydney is expected to follow.

As at 2 November 2014	Hong Kong	Singapore	Taipei	London	Frankfurt & Paris	Seoul	Luxemburg
Year of establishment	2003	Feb-13	Dec-12	Jun-14	Jun-14	Jul-14	Sep-14
Market Positioning	Global RMB Centre & Hub - Pioneers	Asean Hub	Cross-Strait Trade Hub	International Capital Markets Hub	European Largest Trade Partners	North East Asian Trade	Global Fund Management
Official Clearing Bank	Bank of China Ltd (Hong Kong Branch)	Industrial & Commercial Bank of China Ltd (Singapore Branch)	Bank of China Ltd (Taipei Branch)	China Construction Bank Ltd (London Branch)	Bank of China Ltd (Frankfurt & Paris Branches)	Bank of Communications Co. Ltd (Seoul Branch)	Industrial Commercial Bank of China Ltd (Luxembourg Branch)
RMB Bond Market	Mature market for dim sum bonds	Mature market First RMB bond issued 27 May 2013 denominated as "Lion City Bonds"	Matured market First RMB bond issued March 2013 denominated as "Formosa Bond"	Developing Market First RMB non-chinese sovereign bond October 2014	Developing Market First RMB bond issued in Frankfurt May 2014 & Paris July 2014	Developing Market First RMB bond issued October 2014	Mature market First RMB Bond issued exchange to list May 2011
RMB Customer Deposits	RMB 937bn as 07/14	RMB 254bn as 06/14	–	RMB 14.5bn as 06/13	Paris RMB 20bn as 15/09	RMB 11.3bn as 05/14	RMB 67.2bn as 06/14
Currency Swap facility with China	RMB 490bn	RMB 300bn	In negotiations	RMB 200bn	RMB 350bn ECB	RMB 360bn	RMB 350bn ECB
Quota for RQFII Scheme	RMB 270bn	RMB 50bn	RMB 100bn	RMB 80bn	RMB 80bn	RMB 80bn	Awaiting annoucement

Singapore RMB 250bn as at June 14
http://www.bloomberg.com/news/2014-09-22/malaysia-tigers-chase-singapore-lions-in-yuan-race-asean-credit.html

Seoul RMB 11.33bn as at May 14
http://www.bloomberg.com/news/2014-07-03/won-yuan-trading-on-agenda-as-china-south-korean-leaders-meet.html

HKG & Taipei Deposits
http://www.chinapost.com.tw/business/global-markets/2014/09/12/417004/Deposits-in.htm

** ECB's RMB 350bn bilateral Swap line covers Frankfurt, Paris and Luxembourg jointly.
Luxembourg
http://www.rmb-business.com/en/latest-news/news/2014/09/renminbi-volumes-in-luxembourg-continue-to-increase

Singapore's rise to prominence

As Hugh Killen Westpac's Global Head of Foreign Exchange suggests, Sydney's end state is likely to be similar to that of Singapore. Singapore has long been a key trading hub between China and the ASEAN region. Today it is the second preferred listing place for renminbi bonds after Hong Kong and plays a vital role in China's relationships with other ASEAN countries.

Trade between China and Singapore alone accounts for nearly 20% of China-ASEAN trade. In order to boost renminbi usage in trade settlement, China and Singapore agreed to a set of arrangements in April 2013 that included making ICBC Bank, China's largest state bank, the official renminbi clearing bank for Singapore. This made Singapore home to the only renminbi clearing bank outside of Greater China and cemented its role as a bridge between China and Southeast Asian countries in trade, investment and capital movements. Just one month later ICBC Singapore started a renminbi clearing service and by the end of the year, 67 institutions had opened renminbi interbank accounts. Total clearance volume reached RMB2.6trillion[14].

In May 2013, Standard Chartered issued the first renminbi denominated bond in Singapore. Since that time, five other banks have issued renminbi bonds, raising a total of renminbi4.5 billion, according to figures released by the Singapore Stock Exchange.

Singapore – The lessons for Sydney

The trajectory of Singapore shines a light on the journey Sydney may take as a renminbi settlement hub. Reasons for Singapore's success include:

- Singapore is one of the world's most active foreign exchange trading centres and Asia's largest after Japan;
- Its geographical position allows it to serve Southeast Asia, the Middle East and India, strengthening its position as a centre for currency trade in Asia;
- A history of favourable US dollar lending rates and non-deliverable forward rates compared with Hong Kong would appeal to large corporates seeking to diversify risk; and
- Singapore is Asia's principal trading hub for key commodities that China imports, something seen as likely to enhance its position as the preferred treasury centre for multinational corporations.

In less than two years since the first trades were settled in renminbi, Singapore has outstripped London for offshore renminbi trading and is now one of the largest currency trading hubs in the world. Indeed it is widely viewed as a regional funding centre, supporting the liquidity of the Asian markets and partnering China in creating offshore use of the renminbi.

14. Source: PWC "Where do you renminbi?" https://www.pwc.lu/en/china/docs/pwc-where-do-you-renminbi.pdf

15. McKay, Huw (2007) "Reforming China's Exchange Arrangements: monetary and financial sovereignty, sequencing and the foreign exchange market" in Garnaut, Ross and Song, Ligang (eds.) China: Linking Markets for Growth (Asia Pacific Press: Canberra

The long road to liberalisation – A history

China pegged its currency to the US dollar in 1994 in a bid to tame inflation, at a time when domestic prices were rising sharply. This was a conventional move at the time. Many emerging markets chose to peg their exchange rates in this era, with hyperinflation a huge issue in Latin America and post Cold War Eastern Europe. China's own problems were not as severe as in those other jurisdictions, but leveraging off the inflation-fighting credibility of the US Federal Reserve was a pragmatic move. Around the same time China unified onshore currency trading with the establishment of the Shanghai-based China Foreign Exchange Trading System (CFETS), which took the place of more than 100 independent centres. Initially, only the US dollar and Hong Kong dollar were traded. The yen was added in 1995, the euro in 2002 and in May 2005 eight other currencies were added.[15]

The onset of the Asian financial crisis in mid-1997 was the first major challenge faced by the new system. Massive currency devaluations by competitors and neighbours such as Thailand, South Korea and Indonesia created enormous problems for China, despite its closed capital account shielding it from the worst of the immediate financial contagion. China's export industry was plunged into recession, a substantial number of provincial government-linked investment companies engaging in speculative foreign activities were heavily impacted, and domestic industries still in transition from state-owned enterprise reforms in the early and middle 1990s faced an additional shock. Already weak from the poor economic performance earlier in the decade, bank balance sheets were awash with bad loans.

The Chinese authorities were faced with a very difficult choice. Liberalise the currency and allow it to drop in value to remain competitive alongside neighbouring currencies or maintain the currency peg to the US and face deflation as an offset for the direct loss of competitiveness, but win some friends in the process. Faced with a grim economic outlook either way, they chose the latter, more difficult course. A lengthy period of deflation and unemployment ensued, despite major attempts at fiscal stimulus. Even so, China's leaders had just usefully observed how not to approach financial liberalisation, with the Thai, Indonesian and Korean examples as ones to possibly avoid.

Continued over

China's period of subdued growth came to an end with the dramatic success of its World Trade Organisation accession in 2001. This was a true 'coming out' party. The move bound policymakers to a rules-based system of economic management. Until this point, international companies had been hesitant to invest in China, following a raft of losses in the early 1990s, when the first multinational companies (MNCs) engaged. The result was a large influx of capital from MNCs, a surge in export growth and a rapid expansion of the current account surplus, triggering calls from the United States and European Union for the renminbi to appreciate. Westpac Senior International Economist Huw McKay argues: "It was at this point that the political economy of exchange rate reform really kicked into gear." Beijing initially resisted this political pressure, however by the mid-2000s it was ready to act, as maintaining a hard peg was no longer seen to be in their own best interests.

The peg exit ocurred in July 2005, with a 2.1% revaluation from 8.28 yuan per dollar to 8.11, with a 0.3% daily trading band. The new regime technically allowed for both appreciation and volatility, but the authorities moved cautiously in the first year or so. More rapid gains were allowed in the two years leading into the GFC, as domestic inflation and very strong capital inflows (most collected as foreign exchange reserves) made controlled currency appreciation an attractive option for the PBOC. Subsequently, the advent of the GFC saw the authorities reinstate a stable USD/CNY rate, while a return to more normal global growth conditions from 2010 encouraged a further phase of currency gains. These persisted until the early part of 2014, when the authorities engineered a decline in the exchange rate, while signalling that the major catch-up appreciation of the 2005-2013 was now mature, with the rate up by almost one third over that time.

The mid-2000s also saw a dramatic uplift in China's domestic economic development, fuelled by industrialisation and urbanisation. An impressive build out of national transport infrastructure, large scale expansions of energy generation and distribution assets and massive housing construction meant very strong demand from China and soaring commodity prices.

While the post financial crisis period spurred a sharp acceleration in the pace of renminbi internationalisation, China had a well-established strategic objective to pursue internationalisation.

China now finds itself part way along the liberalisation path. Questions remain about the precise path and the exact timing. But there is an emerging consensus regarding the ultimate destination.

Conclusion

While China is an established global economic power, the country's economic might has not yet been matched by its global financial integration. This will not persist in the long run, as the Chinese authorities are clearly committed to a liberalisation process and have already taken a number of important deregulatory and market-oriented steps. They have allowed flexibility in the value of the exchange, decreased the central bank's role in FX matters, presided over a steady expansion of cross border flows, and have introduced a number of reform initiatives aimed at increasing the depth, breadth and sophistication of private financial markets.

The Australian government, corporates and financial institutions have been proactive in grasping the opportunities in response to this process of change. Australia is now at a positive tipping point in its relationship with China. The signing of a bilateral local currency swap agreement between the Reserve Bank of Australia (RBA) and the People's Bank of China (PBOC) in March 2012; the achievement of direct trade between the currencies in April 2013; the RBA beginning to hold renminbi reserves and Chinese government debt; and the Australian Securities Exchange (ASX)-Bank of China renminbi settlement service, which was instituted in 2014, have all contributed to furthering financial ties between the two economies who are so closely related in the real sector.

With already close ties with China growing stronger, as well as the establishment of a Sydney settlement hub for renminbi trade, Australian businesses and commerce now stand to benefit as transacting with China becomes simpler and easier.

A better way to do business

By leveraging our capabilities in Asia and extensive experience in international banking, Westpac Institutional Bank provides you with a strategic advantage when it comes to doing business in RMB.

As one of only two Australian banks allowed to trade RMB directly, and with approval to establish a sub-branch in the Shanghai Free Trade Zone, we are at the forefront of RMB internationalisation. Drawing on our 40 years of experience in Asia, our focus is on supporting the growth of the China corridor for the benefit of Australasian companies.We understand the complexities of the RMB internationalisation process and will work with you to ensure doing business in RMB is as simple as possible.

Our knowledge and insights translate into innovative solutions that help maximise your opportunities and manage risk. We help you make informed decisions by sharing our insights through resources such as the *Westpac MNI China Consumer Sentiment Survey,* the *Westpac-BREE China Resources Quarterly*, *Phat Dragon*, our acclaimed weekly chronicle of the Chinese economy, and our research portal WIB IQ.

No.1
Australian Bank for FX globally[1]

No.1
Best Local Trade Finance Bank in Australia[2]

No.1
Most accurate forecaster of the RMB, globally[3]

Maker
AUD/CNY Market Maker in China[4]

Foundational
Approval to establish ShanghaiFree Trade Zone Sub-Branch

Westpac Institutional Bank

Westpac Institutional Bank is one of Australasia's leading specialist financial services managers and distributors. We manage the financial needs of corporate, institutional and government clients that are based, or have interests in, Australia and New Zealand.

We are a leading provider of wholesale banking services in financial markets, debt capital markets and transactional banking. Reflecting our commitment to providing superior banking services, we have been named the No.1 Lead Domestic Transactional Bank for 11 years running[4] as well as the No. 1 Australian Bank for FX globally[5].

At Westpac Institutional Bank, we are committed to partnering with our clients to deliver innovative solutions that support their business growth. We are equally focused on creating a sustainable future for our employees, shareholders and the community – a commitment that was recognised at the World Economic Forum where Westpac was named The Most Sustainable Corporation In The World for 2014[6].

1. Euromoney FX Poll 2014. Measure of market share from 14,050 FX industry votes. 2. Global Trade Review Asia Leaders in Trade Poll 2014. 3. SWIFT RMB Tracker March 2014. Westpac ranks no.1 for citations as 'lead' transactional bank from 2004-2014. Westpac ranks no. 1 in the Peter Lee Associates relationship strength index score across the total respondent base.
5. Euromoney FX Poll 2014. Measure of market share from 14,050 FX industry votes.
6. Top-ranked in the Global 100 list of the world's most sustainable corporations, announced at the 2014 World Economic Forum.
7. Bloomberg Rankings, June 2013. Bloomberg ranked currency forecasters based on three criteria: margin of error, timing (for identical forecasts, the ones made earlier received more credit) and directional accuracy (whether or not the movements the forecasts implied coincided with the currency's overall direction). The ranking, which used forecasts submitted to Bloomberg's (FXFC) function, was for the four quarters ended on June 30, 2013.