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The new Chinese CNH – the next global currency?

From July this year the Chinese Yuan, outside of Mainland China (CNH), is a fully convertible currency. This opens up a range of new possibilities for entities that have cross-border trade with China – or indeed for investors. The new rules enable foreign exporters and importers to invoice in CNY thus providing the means for them to improve margins as the CNH is trading at a stronger rate than the CNY traded in Mainland China. For investors this is the birth of a new market and in the years to come we believe that CNH gradually will become an important part of every large investment portfolio.

In response to this development SEB is now as one of the first international banks able to offer CNH services to our customers outside of China. SEB now provides a range of interesting products including cash management, trade finance and foreign exchange in CNH. This enables our customers to conduct cross-border trade and for investors to trade in FX and invest in CNH denominated bonds. Together with our existing services from our SEB branch in Shanghai this gives our customers a broad offering both onshore and offshore in China.

The CNH -a small currency revolution

China has traditionally kept a tight control over its currency and financial markets through rigid regulations and interventions. As a consequence the USD has become the leading currency for foreign trade. Using a foreign currency however comes with a price. It both has monetary costs (seignorage) and loss of economical influence. As the Chinese share of world trade now is reaching 10% this cost has become too high. Consequently China has decided to deregulate the CNY outside of China, creating a new market that is named "CNH" by market participants.

The recent deregulation of the CNH has paved the way for the renminbi to become a world currency over the next several years. We consider the potential consequences of these moves significant. The liberalization of the CNH will now enable foreign trade in CNH and enable foreign central banks to use CNH as a reserve currency. This is important to build up the Yuan as an international currency.

The new CNH has had a flying start since July this year. A total of 340bn Yuan of trade transactions have settled so far but most of this by Chinese entities and only a small share by international companies. We expect the market to increase exponentially in 2011 as international companies start to change their invoicing to CNH.

What you can do…

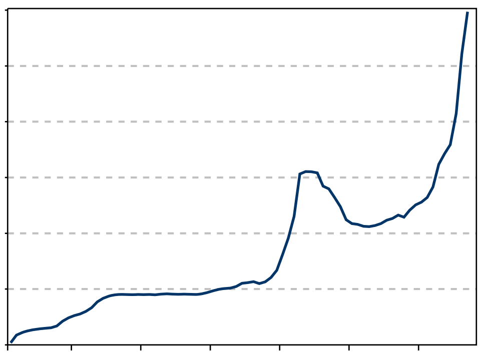
The development of CNH opens a wide range of interesting opportunities for corporates and institutions.

SEB

- **Firstly**, CNH is no longer subject to any geographical restrictions and any corporate or private investor may now operate a CNH account. As the CNH is fully convertible it may be included in global cash pools etc.
- **Secondly**, CNH account may be used to settle cross-border trade transactions with Mainland China including both exports and imports of goods and services and payment. Please note that dividends are also considered cross-border trade. As the CNH is trading at a premium to the Mainland CNY (see page 3) this is in particular attractive for exports to China and dividend payments as one gets more hard currency for every Yuan. The CNH can also be used for letters of credit, guarantees and other trade finance products.
- **Thirdly**, the new CNH market enables overseas companies and private investors to freely invest in the CNH. As a result, the CNH can be bought or sold for whatever purpose and transferred to any account. Products available include FX spot, FX outright MM and FX Swaps. Overseas investors may now freely deposit CNH or invest in the newly created CNH bond market in Hong Kong which currently comprises around 20 issuers, mainly Chinese banks but also global multinational companies and the AAA rated ADB (Asian Development Bank).
- **Fourthly**, corporates are now able to fund themselves in the offshore market at substantially lower rates than in Mainland China (via bonds or FX swaps). Several overseas companies have already used funds raised offshore to finance their mainland subsidiaries. However, Chinese authorities have no clear regulations for doing so. Please contact our SEB office in Shanghai for further information.

CNH market growing quickly

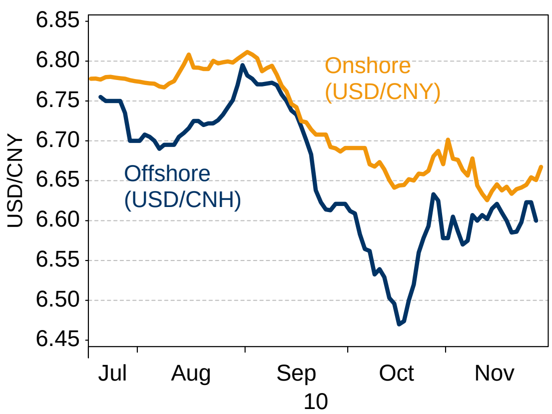
Although liquidity in the new CNH market is still lagging the large CNY onshore market, it is rapidly improving. In the spot market the estimated turnover is USD 500-800mio per day (up from USD 100mn in August). Average ticket size is USD 5-10mn with a spread of 50-60bps. In the forward market liquidity is still limited in the longer tenors but quite good in the front-end as many Chinese banks are liquid in CNH from their deposits. CNH deposits with offshore banks are increasing rapidly and are currently standing at more then CNH 200bn up from CNH 60bn end of 2009. Looking ahead estimates are that deposits will continue to increase exponentially enabling the CNH to become a world currency.



CNH pricing

Contrary to the Mainland CNY the CNH is freely floating without any interventions from PBOC. This opens up for investors that want an exposure to the Yuan but that do not have access to the CNY or the NDF markets. Due to the expected appreciation of the CNY the CNH has since the start of July traded with a premium. The premium has been quite volatile reaching 2.5% at the peak and is currently at 0.5%. Going forward we expect this premium to remain as we consider the CNY as fundamentally undervalued. However, while the CNH is set to remain stronger than its onshore equivalent the extent of the difference is set to continue to vary. At present levels however, we consider CNH very attractive as an investment.

USD/CNY spot



Source: Reuters EcoWin

As mentioned, with this rate differential it becomes attractive for foreign exporters to invoice in CNY and sell the export proceeds in the offshore CNH market.

Reuter pages references:

CNY Overview <CN/OFFSHORE>

CNY onshore FX spot <CNY>
CNY onshore FX Fwd <CNYFWD>
CNY onshore MM <SHIBOR>

CNH offshore FX spot <CNY=W>
CNH offsh. FX Fwd <CNYFWD=W>

The New Chinese Renminbi (CNH) FAQs:

Q: Do I need to open my CNH account with a bank in Hong Kong?
A: No. Although all foreign banks are required to hold a CNH account with Bank of China in Hong Kong it makes no difference where outside of Mainland China the bank is located.

Q: Can I consolidate my mainland operations and associated liquidity into my international cash pools?
A: No. But liquidity held in a CNH account can be treated & used like any other currency.

Q: How do I cover my CNH account?
A: Like any other convertible currency, FX swaps or MMs.

Q: Can I use CNH liquidity derived from an FX Swap or bond to finance my investments in Mainland China?
A: Theoretically yes. Several overseas companies have already used funds raised offshore to finance their mainland subsidiaries. However, Chinese authorities have no clear regulations for doing so. Please contact our SEB office in Shanghai for further information.

Exporting to China
Q: I am a corporate exporting to China. How would CNY invoicing be done in practice? Does my customer need to have any special license?
A: As your customer is an importer it does not need any special permission to pay invoices cross-border. It needs to be in a "pilot region" but currently 95% of China is covered. The first step is to set the invoice in CNY. See to it that the Chinese importer ensures that all documents related to the actual imports (customs etc) are set in CNY. At maturity of the invoice the Chinese importer will contact their local bank and remit a CNY payment to your account

outside of China. You may then decide to either convert the CNY (or now CNH) to another currency or place it as a deposit. You may hedge this flow in advance via FX forwards or NDFs. The hedge could be done against other currencies than USD like EUR or SEK.

Q: How much money could I save by invoicing my exports in CNY?

A: During the last few months the savings would have fluctuated between 1-4% if one would also used the NDF market as a FX hedge. Contact SEB for more info on this.

Importing from China

Q: I am a corporate importing from China. How would CNY invoicing be done in practice? Does my supplier need to have any special license?

A: As a Chinese exporter your supplier needs to be a pilot enterprise. The number of pilot enterprises has increased substantially lately. Your supplier will send you an invoice in CNY. At maturity you contact SEB and either buy the CNH in the offshore market or you instruct SEB to acquire CNY at the onshore rate. The rate onshore is currently more favourable for buying yuan.

Q: How much money could I save by invoicing my imports in CNY?

A: By using the onshore rate the rate would be the same as for USD invoicing. However, many Chinese suppliers add an extra margin for the currency risk so indirectly this may improve pricing.

Q: Do I need any documentation as an overseas company either exporting to or importing from Mainland China?

A: Non-residents are not required to present any documentation; only the local counterpart.

Dividends

Q: We are cash rich in China and we plan to make dividend payments. Should we use the onshore or offshore?

A: Dividend payments are also part of the cross-border trade framework. This means that the dividend could be made in CNY to later be converted at the present favorable rate in the offshore market.

Q: Who do I call if I want to make FX transactions in CNH?

A: Your usual FX sales contacts though we recommend doing so during Asian trading hours when liquidity is better.

Investments and trading

Q: Can I take FX positions in the offshore market?

A: Yes, the CNH is fully convertible. In particular we believe there will be interesting trading cases developing from playing the offshore FX outright against the NDF market. We also see value selling USD/CNH at present levels.

Q: We have decided to invest in China but we don't know when it will materialize. We are concerned about the appreciation of the CNY. How would we hedge this future investment?

A: An alternative to using NDFs could be to buy CNH spot and invest in CNH denominated bonds issued in Hong Kong. There are several issues with high ratings. The yield is limited but will give exposure if the yuan appreciates

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