FINANCIAL REVIEW

SE Financial Services

HD **Push to enhance yuan's status**

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WC 1,356 words
PD 28 July 2014
SN The Australian Financial Review
SC AFNR
ED First
PG 28
LA English

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In April, Chinese state-owned steel maker Baosteel bought 175,602 tonnes of iron ore from Rio Tinto, worth about $US21 million ($22 million).

As the ship left the Pilbara port and headed north, all seemed innocuous – just another load of rock on its way to power the great Asian economic miracle. But this deal was far from normal. It was Australia's first iron ore sale in Chinese currency. Rather than paying Rio Tinto US dollars – the dominant currency for commodities sales – Baosteel handed over 114 million in yuan ($19.67 million).

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Announced by Prime Minister Tony Abbott during a speech to business leaders in Beijing, the deal was highly symbolic; Rio said it underscored its "deep and enduring relationship with China".

But it was also strategic. Rio's iron ore chief Andrew Harding said that while the US dollar would remain the benchmark currency for iron ore pricing, this sale in yuan, also known as renminbi (RMB), was "an important step to allow both parties to develop and demonstrate capability in renminbi-denominated international trade transactions should the market ever move in that direction".

With less than 1 per cent of Australia's merchandise trade with China currently invoiced in yuan, institutional bankers facilitating business in China are encouraging clients to think more like Rio.

In its chapter on international integration, the financial system inquiry interim report observed this month that currency and capital account liberalisation in China is expected to intensify in the next decade and "this is likely to have wide-ranging implications for the Australian financial system".

The report highlighted more Asian capital flows, deeper capital markets and the "increasing payment of physical trade using RMB".Banks get ready to profit

Banks are positioning themselves to profit from the rise of renminbi. ANZ Banking Group's presentation slides for its investor and analyst shindig in Hong Kong last week point to the competitive advantage of its "full suite of onshore and offshore RMB products" and its desire to "build new product capability across RMB". In its Caged Tiger report in March, Australia's most Asian-focused bank said more invoicing in RMB and a growing RMB deposit base in Sydney "will be important developments in streamlining trade and reducing transaction costs between Australia and China as well as developing a more internationally oriented commercial banking system".

Westpac – which, along with ANZ, has been granted market-maker status by China for the trading of yuan and Ausralian dollars – is also ramping up RMB capabilities. An update to its internal finance and risk management systems to allow it to more broadly deal in yuan is almost complete. As Chinese economic liberalisation evolves, Paul Verschuer, Westpac's managing director for foreign exchange, carbon, commodities and energy, expects demand for RMB accounts, payments services and foreign exchange to increase, and develop into RMB-denominated debt capital markets services, trade finance options and derivative products for hedging.

The banks' quest to grow the yuan market has received the imprimatur of the federal and NSW governments and the Reserve Bank of Australia, which are all strong supporters of the internationalisation of the Chinese currency.

In a speech to a high-level industry round table hosted by NSW Trade & Investment in Sydney last week, RBA deputy governor Philip Lowe pointed to several initiatives pushed by the central bank to develop the market, including the 2012 bilateral local currency swap agreement with the People's Bank of China to provide confidence that RMB liquidity will be available through a "backstop" channel in a situation of market disruption. He suggested other developments were in store. The announcement of a yuan clearing bank in Australia, which will provide liquidity from the People's Bank of China and direct access to China's interbank yuan payments system, will be made "over the coming months," Lowe said.

The RBA is also seeking quotas for Australian-based financial institutions to invest in mainland China under the Renminbi Qualified Foreign Institutional Investors scheme.ASX to strengthen ties

The ASX is also building market infrastructure to deepen linkages with China. Its chief executive Elmer Funke Kupper sees a future where RMB-denominated bonds, equities and derivatives are traded on the ASX.

On Monday, the ASX's new yuan settlement service will go live, allowing yuan transactions to be settled in real time through Austraclear.

Treasury, the RBA and the Hong Kong Monetary Authority have also been facilitating conversations with industry. The Australia-Hong Kong RMB Dialogue Group has met twice, bringing together senior bankers to discuss how to promote use of the yuan.

After meeting in Hong Kong in May, the dialogue's RMB Working Group – comprising Treasury, the RBA, the big four Australian banks, China banking giants ICBC, Bank of China and China Construction Bank, the Australian Securities Exchange, law firm King & Wood Mallesons and some international banks operating in the region including Standard Chartered, HSBC and JPMorgan – was tasked with driving detailed conversations with business about engaging with the offshore yuan market in Australia.

Lowe emphasied the importance of this last week, saying that for the yuan market in Australia to flourish, "Australian corporations must be able to identify a clear business case for paying, receiving, lending, borrowing and investing in RMB. Over time, I think this will happen, but there is more work to be done."

A survey by HSBC released last week found Australian companies have been slow to recognise the yuan as an enabler of trade and risk, falling behind attitudes around the globe. Just 9 per cent of the Australian companies surveyed had traded in yuan (compared with a global average of 22 per cent), HSBC said, while fewer non-users of yuan in Australia expect to begin using it compared to the global average.Perception of heightened risk

Westpac's Verschuer reckons many customers trading with China display inertia because they want deals to be simple and they see the government controls around the yuan as heightening risk. "You will see this gradually grow, but the growth will be correlated to how much certainty we get on China's liberalisation and a freely tradeable renminbi, because only then will see liquidity develop and investors be willing to hold risk in RMB," he says.

There are also hurdles on the Chinese side.

A Centre for International Finance and Regulation (CIFR) report, Internationalisation of the Renminbi, published in March, found some Chinese banks have been applying a surcharge to Chinese clients invoicing in yuan to protect their high-margin foreign exchange operations under the current system.The report also said discussions with senior executives at a number of large commodity exporting companies suggested they were not seeing any pressure from Chinese importers to invoice in yuan.

So what might the catalyst be for more Chinese companies to insist transactions are denominated in yuan? One could be further change to China's exchange rate policies. As it liberalises its capital account, China is likely to widen the band between which its exchange rate can fluctuate, absorbing some of the impact of increased capital flows but also increasing exchange rate volatility.

The CIFR report said this may encourage more Chinese companies to negotiate to pass on the increased exchange rate risk to their offshore counterparties.

The head of commercial banking for HSBC in Australia, James Hogan, agrees **Chinese** companies will "look favourably on foreign partners using their currency, as it reinforces commitment to **China** and eliminates foreign exchange risk from their cost base."

There is also a potential pricing dynamic that might encourage more yuan deals. Hedging foreign exchange risk is more expensive in **China** than on global markets. A **Chinese** importer pricing a deal in yuan could pass on the costs they save from not having to hedge to the exporter who can hedge more cheaply outside **China**, creating a potential win-win.

As the CIFR report noted: "If one large commodity exporter broke ranks, invoiced in RMB and received a significant price advantage in the process that outweighed their currency hedging costs, this could potentially have a snowballing effect."

CO baois : Shanghai Baosteel Group Corp | craaus : Rio Tinto Ltd | rtz : Rio Tinto PLC

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PUB Fairfax Media Management Pty Limited

AN Document AFNR000020140727ea7s0002c

