OBSERVATION

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CANADA ON ITS WAY TO BECOME A LEADER IN RENMINBI TRADE

Highlights

- Canada will host the first Renminbi (RMB) trading hub in the Western Hemisphere. This development is expected to deliver significant benefits to Canadian businesses, financial institutions, and the overall economy. The benefits for Canadian companies could range from lower transaction costs and discounts on import prices to increased exports and longer payment terms.
- Allowing direct trade in RMB will reduce transaction costs for Canadian businesses and could save Canadian firms up to $6.2 billion over 10 years. This is particularly relevant for small and medium-sized businesses trying to expand into China as they could presumably direct those savings to improving their productive capacity.
- The trade sector is likely to be the big winner with an estimated $21 to $32 billion gain over the next decade thanks to increased exports. Importers could also generate up to $2.8 billion in savings over the same period.
- From a provincial perspective, British Columbia is expected to generate over $9 billion over the next 10 years as a result of increased trade with China. Saskatchewan and Quebec would not be left behind either, with $4.4 and $2.3 billion worth of additional exports, respectively.
- The trading hub will also provide opportunities to Canada's financial institutions. They could offer a wide range of financial services and RMB-denominated products to not only to local businesses, but to all firms that have commercial relations with China and operating west of Europe.

During his recent visit to China, Prime Minister Stephen Harper announced that Canada has reached an agreement with China to host the first North American Renminbi (RMB) trading hub. The Canadian hub will allow direct exchange and trade operations between the RMB and the Canadian dollar (CAD). As a result, Canadian firms doing business with Chinese partners will no longer be required to settle their transactions through an intermediate currency, thereby mitigating currency risks and reducing transaction costs. Canadian exports to China are also likely to intensify, especially as Chinese importers will no doubt appreciate the opportunity to transact in their local currency. In addition, provinces that already have significant commercial ties with China, such as British Columbia, will likely be the big winners.

While the trade sector should reap most of the rewards, Canadian financial institutions could also benefit from the first mover advantage. This could be made possible by being able to provide a broad range of services and RMB-denominated products to local businesses and firms. China is the second largest economy in the world and will continue to increase in importance which means considerable financial transactions will be taking place in its currency. As such, the ability to trade in RMB represents a valuable advantage for Canada.

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A brief history of Canada's RMB-trading hub

Both Vancouver and Toronto were being considered for possible locations for the first North American RMB hub, although Toronto managed to secure the RMB clearing bank, namely the Canadian branch of the Industrial and Commercial Bank of China.[1] The chosen city will join a short list of offshore RMB centres which includes, among others, Hong Kong, Singapore, and London. Canada offers many desirable features such as a sound banking system and a convenient time-zone that will allow continuous RMB trading after the closing of Asian and European markets.

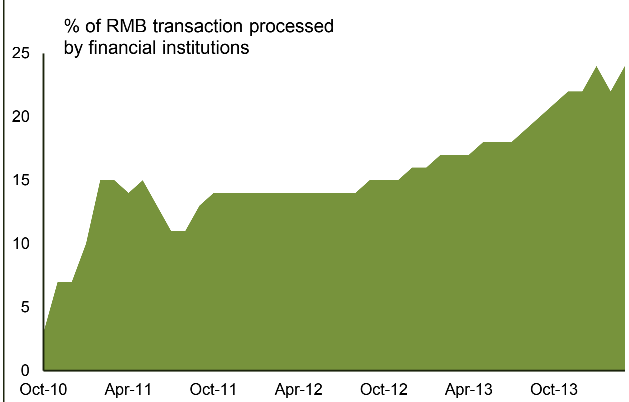
This currency trade agreement is the latest concluded by the Chinese government to achieve the internationalization of its currency. This internationalization strategy consists of increasing the use of the RMB in the settlement of cross-border transactions through the development of an international RMB offshore market. The foundations were laid in the early 2000s when the government allowed foreign investors to buy RMB-denominated shares in the mainland Chinese stock market under its RMB Qualified Foreign Institutional Program (RQFII). That program has now been extended to Canada, whose financial institutions will be granted an initial quota of RMB 50 billion to invest in the Chinese securities market.[2]

Along with several other policies that are being implemented by the authorities, the RQFII was motivated by the fact that the RMB is underutilized relative to the size of the Chinese economy. In 2011, it ranked as the 21st currency in terms of size of global payments and only 0.24% of global transactions were settled in RMB. Yet China represented more than 11% of international trade. However, it now looks as though their strategy is paying off as the RMB jumped to 7th place as of September 2014, raising its share in global payments to 1.72%.[3] Moreover, the increasing share of RMB payments taking place outside China and Hong Kong suggests that offshore centres will likely be the driving force behind the internationalization of the Chinese currency in the coming years (Chart 1).

How would a RMB-trading hub work?

The Bank of Canada and the People's Bank of China (PBoC) have signed a 3-year currency swap deal worth $30 billion CAD.[4] The hub will be authorized by the PBoC to complete RMB-denominated transactions, which will allow direct operations between the CAD and the RMB. The two countries also agreed to establish a clearing bank in Canada to promote the use of RMB in cross-border transactions, which should greatly facilitate bilateral trade and investment.

CHART 1: RMB PAYMENTS IN "TRULY OFFSHORE" CENTRES*



Source: SWIFT
* Truly offshore centres refer to RMB centres outside China and Hong Kong

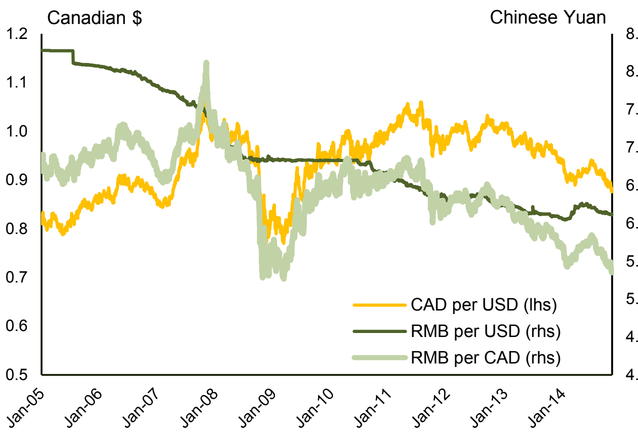
Since the CAD is not directly convertible to the RMB, Canadian companies doing business with Chinese counterparts have had to settle their transactions through a third-party currency – usually the U.S. dollar (USD). With a Canada-based trading hub, those same companies could make direct payments to their Chinese partners in RMB. China currently has a managed-floating exchange rate policy, which means the exchange rate is fixed daily by the PBoC depending on the demand arising from investors. Since the PBoC will be responsible for the liquidity supply, the platform will be able to adequately handle large transactions and the predictability of the exchange rate will be an added benefit.

A broad range of benefits to follow

While the benefits that will flow from an RMB-trading hub are many, probably the most significant one relates to lower transactions costs. Multiple currency conversions can involve significant transaction costs, as well as a foreign exchange risk, since the outcome of the operations will depend greatly on the fluctuations in the US and Canadian dollars. While the exchange rate between the USD and the RMB tends to remain steady, that is not the case for the Canada-U.S. exchange rate, which exhibits more volatility (Chart 2).

As such, the trading hub will be characterized by the introduction of a direct exchange rate between the RMB and the CAD, which will certainly help mitigate currency exchange risks. According to the Canadian Chamber of Commerce, this could save businesses close to $6.2 billion

CHART 2: A RELATIVELY STABLE CHINESE CURRENCY



Source: Wall Street Journal/Haver Analytics

in transaction costs over the next decade. This is particularly relevant for small and medium-sized business trying to expand into China as they could presumably direct these savings to improving their top lines. Alternatively, they may consider charging lower prices to Canadian customers as a result of lower transaction costs.

Benefits could also emerge from an operational perspective considering that businesses would be able to negotiate more favourable payment terms with their Chinese partners. This is due to RMB settlements qualifying for an extension of payment terms up to 210 days, compared to the 90-day deadline for deals settled in foreign currencies.[5]

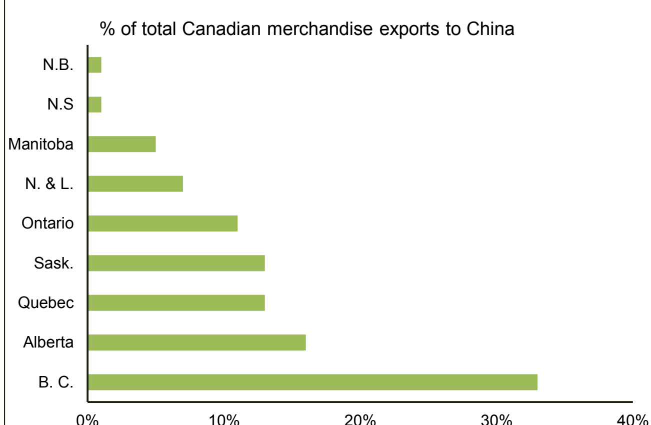
The trade sector is likely to reap the majority of the benefits

China was Canada's second largest and fastest growing commercial partner in 2013. Canada's exports to China grew by 208% between 2004 and 2013 to $20.5 billion. Although imports from China grew at a slower rate over the period (119%), they remained considerably higher, at $52.7 billion in 2013. As a result, Canada's merchandise trade balance with China recorded a $32 billion deficit last year. As exports to China are mainly commodities and agricultural products, selling those products in RMB could allow Canadian businesses to build up higher margins and stand out from international competition. This could also reinforce trade relationships between both countries and promote Canada's trade diversification strategy towards Asian markets.

Canadian exports to China are also likely to intensify, due to a known bias from Chinese companies towards their local currency and the possibility that Chinese partners can increase their demand for Canadian products as a result of diminished transaction costs. Indeed, a survey released by HSBC earlier this year revealed that more than half of the Chinese companies questioned are willing to offer a discount to their partners that would use the RMB, with 20% of the respondents estimating a discount of 3% or more. Along with these potential discounts, direct benefits from an increase in Canadian exports could range from $21 to $32 billion over the next decade.[6] It is hard to predict the number of Canadian firms that will start using the Chinese currency to take advantage of those discounts, but we can assume that the volume of payments in RMB could rapidly escalate with the development of settlement and clearing operations. As reported by the Canadian Chamber of Commerce, those discounts could save Canadian importers up to $2.75 billion over 10 years, adding to export gains.

Looking at the provinces, the big winners should be the ones that already have significant commercial ties with China, such as British Columbia (Chart 3). British Columbia could generate as much as $9.4 billion over the next 10 years from increased exports alone. Saskatchewan and Quebec will not be left behind either, with around $4.4 and $2.3 billion worth of additional exports, respectively, expected over the same period. From a sectoral perspective, the benefits should largely go to the manufacturing (+ $9.5 billion) and agricultural sectors (+ $8.5 billion), followed by the commodities sector which is expected to yield an additional $4.1 billion.[7]

CHART 3: PROVINCIAL EXPORTS TO CHINA IN 2013



Source: Statistics Canada (Canadian International Merchandise Trade Database)

Canadian financial sector well positioned to be a leader in RMB-denominated products

China is already the second largest economy in the world and is expected to continue to increase in importance. This suggests considerable financial transactions will be taking place in its currency and, as such, the ability to trade in RMB represents a valuable advantage for Canada. With the increasing use of the RMB in trade transactions, Canadian financial institutions would be able to provide a wide range of financial services thanks to the first-mover advantage, not only to local businesses but to all firms operating in the Western Hemisphere that have commercial ties with China.

For instance, Canadian banks could offer RMB-denominated products related to trade finance or for investment purposes, such as bonds. Indeed, those receiving payments in RMB may need to invest the proceeds of their trade operations and would gladly welcome instruments that do not require any currency conversion, such as RMB-denominated bonds which investors find quite attractive. As an example, the government of British Columbia issued 2.5 billion in RMB-denominated bonds in 2013; it was initially expecting to receive between RMB 0.5 and 1.0 billion, but the issuance was oversubscribed. Since then, the province has moved further towards increasing its pool of investors as evidenced by a second issuance of RMB-denominated bonds expected in a near future. The issuance was priced at RMB 3 billion in October 2014.

Furthermore, Chinese investors have already expressed a strong interest in investing in Canada. As such, the Canada-China Foreign Investment Promotion and Protection Agreement that came into force in October 2014 will undoubtedly contribute to boost Chinese investments in Canada, especially if investors are offered the opportunity to conduct transactions directly in RMB. In 2013, the stock of Chinese Foreign Direct Investment (FDI) in Canada totaled $16.7 billion; that is almost four times the stock of Canadian FDI to China. This is an increase of 37.9% since 2010.[8]

Bottom Line

The deal between the Chinese and Canadian governments to establish an RMB-trading hub in Canada represents a superb opportunity in terms of trade and investment. For most Canadian businesses, the overall gains could range from lower transaction costs and discounts on import prices to increased exports and better payment terms. Hosting the first RMB-trading hub in Canada has its advantages, especially for financial institutions that could develop a wide range of RMB-denominated products.

While a Canada-based RMB trading hub is an achievement in itself, the success of the operation will greatly depend on the adoption of RMB in cross-border trade by Canadian businesses, and the quality of financial products offered by Canadian banks.

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End Notes

1. Public Notice of People's Bank of China No. 27, PBoC, November 2014.

2. Fresh Progress in China-Canada Financial Cooperation, PBoC, November 2014.

3. RMB reaches record levels of payments activity between offshore centres, SWIFT, October 2014.

4. The currency swap allows the provision of RMB to the Canadian central bank. It is a contract where parties agree to exchange a predefined amount of their respective currencies at a known exchange rate; they also simultaneously agree to reverse the transaction at a specific date in the future.

5. The shorter 90 day payment term is due to the fact that there are additional administrative requirements from the central bank when payment terms exceed that specific period.

6. Doing More Business with China: Why Canada Needs a Renminbi Hub, Canadian Chamber of Commerce, October 2014.

7. The agricultural sector refers to agriculture, forestry, fishing and hunting; and the commodities sector includes activities such as mining, quarrying, and oil and gas extraction.

8. Statistics Canada.