China Alert - June 2011
Pilot Programmes of RMB Settlement of Foreign Investment and Financing Start in Shanghai

1. **Summary**

Based on a news article published on People's Daily Online on 23 May 2011, Shanghai is seeking to achieve a significant breakthrough in the development of cross-border Renminbi ("**RMB**") business. Against a background of China pushing for further "internationalisation" of the use of the RMB, this important development seems to mark a significant step towards full convertibility of the RMB, which would further facilitate cross-border trade, investment and financing in or from the People's Republic of China ("**China**" or "**PRC**").

2. **Background**

Under the current PRC foreign exchange regime, the RMB is fully convertible with respect to current account transactions (including trading transactions), but is not fully convertible with respect to capital account transactions (including foreign direct investments and securities investment-type transactions).

In a current account transaction, foreign exchange ("**forex**") can be freely remitted into China and converted into RMB at designated banks, and, on the other side, RMB can be freely converted into forex at designated banks and remitted outside of China. Any receipt or remittance of foreign currency must be based on a genuine and lawful underlying transaction. For example, a Chinese exporter exports goods to the United States ("**US**") and is paid in US dollars by the US importer. Those US dollars received by the Chinese exporter can be freely converted into RMB at a designated foreign exchange bank in China, as long as the bank is provided with relevant documents (such as the export contract, etc.) which prove the transaction meets the "lawful" and "genuine" criteria.

In a capital account transaction, forex can only be remitted into China and converted into RMB, and RMB can only be converted into forex and remitted outside of China upon registration with, or approval by, the State Administration of Foreign Exchange ("**SAFE**"), the authority responsible for the administration of forex conversion and remittance, or its competent local counterparts. For example, if a foreign investor obtains approval to establish a wholly foreign owned enterprise ("**WFOE**") in China (a common form of foreign direct investment), the forex remitted into China as the registered capital of the WFOE can only be converted into RMB upon SAFE registration/approval. Likewise, if a Chinese investor obtains approval to directly invest in an overseas project, the RMB it wishes to invest in the project can only be converted into forex and remitted overseas upon SAFE registration/approval.

Because the RMB is not fully convertible with respect to capital account transactions, this represents an extra hurdle for both domestic and foreign investors that interferes with the free flow of transactions between nations.

The current PRC foreign exchange regime was established in a historical context where China lacked foreign currency reserves and intended to bolster its accumulation of forex. More than a decade later, China has accumulated by far the world's largest forex reserves. Large reserves of forex are generally considered an indicator of a strong economy and currency. However, excessive forex reserves are difficult to manage, as fluctuations in currency markets can cause huge drops (or increases) in the value of forex reserves. Therefore, the Chinese government is now more concerned with balancing control over outflows and inflows of forex (particularly inflows of so-called "hot money" or short term speculative funds), as opposed to controlling outflows of forex only.

Additionally, the US and other overseas governments have, for some time, been trying to pressure China to allow the RMB to appreciate against other major international currencies so as to make Chinese exports less competitive as compared to goods produced in their counties, arguing that an undervalued RMB distorts trade and makes it harder for their exporters to sell to China. China, on the other hand, has always denied any deliberate manipulation of the value of the RMB against other currencies and maintained that the RMB needs to be allowed to rise gradually against other currencies. Reducing forex reserves can, to some extent, alleviate the pressure on a currency to rise in value.

Moreover, following the outbreak of the global financial crisis, there have been large fluctuations in exchange rates of major trading currencies (such as in the US dollar and the Euro). As a result, Chinese enterprises getting paid in overseas currencies face greater risks relating to exchange rates when dealing with other countries. This has given rise to increasing demand for RMB settlement of cross-border business. Against the above background and the announced policy of gradual internationalisation of the RMB (with the launch of a Real Estate Investment Trust in Hong Kong where shares are priced for and paid in RMB being a recent example), the PRC government has launched pilot programmes relating to RMB settlement of cross-border business.

3. Shanghai Pilot Programmes of Cross-border RMB Business

3.1 Existing Pilot Programmes of RMB Settlement of Cross-border Trade, Investment and Financing

As an initial water-testing exercise, the Chinese central bank, the People's Bank of China ("**PBOC**") along with four other state ministries issued the *Administrative Measures for the Trial Renminbi Settlement of Cross-border Trading Transactions* ("跨境贸易人民币结算试点管理办法") on 1 July 2009, which officially launched the pilot programme for RMB settlement of cross-border trading transactions. Under these measures, designated enterprises satisfying certain conditions can, on a voluntary basis, use RMB to settle cross-border trading transactions (such as export and import transactions), and certain commercial banks in China can provide RMB settlement services for cross-border trading transactions by those enterprises. The applicable regions within China within the trial were initially limited to Shanghai and four cities in Guangdong province, and applicable overseas trading regions were limited to the Hong Kong and Macao Special Administrative Regions and members of the Association of Southeast Asian Nations (ASEAN countries).

After the issue of the *Circular on Related Issues Concerning Expanding the Trial Settlement of Cross-border Trading Transactions* ("关于扩大跨境贸易人民币结算试点有关问题的通知") in June 2010, the scheme was expanded to 20 provincial regions within China and to all countries and regions internationally, and the number of designated enterprises was also increased.

China has also been internationalising the RMB through bilateral treaties with major trading partners. For example, on 8 October 2010, China and Turkey issued a joint statement regarding the establishment and development of a strategic cooperative relationship between the two countries. A news report mentioned that both Premier Recep Tayyip Erdogan of Turkey and Premier Wen Jiabao of the People's Republic of China acknowledged that both Turkey and China would use their own currencies in subsequent bilateral trading activities.

As a result of such bilateral arrangements, it is now possible for foreign companies in Turkey to set up a non-resident RMB account in China to receive RMB from local trading partners, or for local trading partners in China to remit RMB directly to their trading partners' RMB accounts in Turkey. The legal basis for the China part of this bilateral arrangement (and which applies to all foreign companies not just those in countries with similar bilateral trading arrangements) is the *Administrative Measures for RMB Bank Settlement Accounts of Overseas Entities* [1] ("**NRA Measures**") which provides for overseas entities to apply for RMB Non Resident Accounts ("**NRAs**") with banks in China (although there are certain limitations on the functions of such accounts and applications for NRAs will need to be approved by the PBOC).

On 6 January 2011, the PBOC issued the *Administrative Measures for the Trial Renminbi Settlement of Outbound Direct Investments* ("境外直接投资人民币结算试点管理办法"). Under these measures, enterprises registered within areas covered by the pilot programme can use RMB to make overseas direct investments. Outbound direct investment is defined as the situation where a Chinese enterprise, subject to obtaining approval from the relevant PRC government authorities, typically the Ministry of Commerce and the National Development and Reform Commission or their corresponding local organs, establishes an overseas venture, acquires all or partial ownership rights, rights to control or operate and manage, or other rights and interests in an overseas project. This includes the establishment of new enterprises, as well as mergers and acquisitions, and equity/share participation.

Consistent with its ambition to become an international financial centre, Shanghai has actively implemented and promoted the above RMB settlement pilot programmes.

Additionally, Shanghai also took the lead in implementing several other pilot programmes relating to RMB settlement of foreign investment and financing including:

(1) overseas remittance of RMB by reducing the number of A shares held;

(2) foreign debts denominated in RMB;

(3) foreign investors increasing the registered capital of foreign-invested enterprises in China using RMB;

(4) payment of the purchase price for transfers of equity interests in RMB in relation to foreign direct investment transactions;

(5) domestic financial institutions (excluding banks) paying dividends in RMB to foreign shareholders;

(6) building overseas RMB "flow-back mechanisms"[2]; and

(7) promoting foreign institutions to invest in the RMB interbank bond market.

By May 2011, the cumulative amount of RMB settled (i.e. forex converted into RMB or vice-versa) in Shanghai exceeded RMB160 billion (approximately US$25 billion), accounting for 13% of the entire national total.

According to one official from the PBOC, the *Administrative Measures for the Trial RMB Settlement of Cross-border Investment and Financing* are currently being drafted and will be issued in the near future. Under these measures, designated foreign enterprises will be allowed to invest in China using RMB, which will be branded as "RMB FDI".

3.2 Future Tasks for Pilot Programmes of RMB Settlement of Cross-border Business

To further facilitate cross-border investment and trade and to accelerate Shanghai's development into a global financial centre, the Shanghai government has now confirmed seven tasks for future pilot programmes involving RMB settlement of cross-border business, including:

[1] Promulgated by People's Bank of China ("**PBOC**") and effective 1 October 2010.

[2] This refers to a mechanism whereby overseas RMB will find its way back to China: allowing foreign direct investment in RMB (see below) will be an important element for creating such a mechanism.

(1) promoting continuous and sustained increases in the amount of cross-border business settled in RMB;

(2) promoting RMB settlement for cross-border export trading transactions;

(3) implementing RMB settlement for outbound direct investment transactions;

(4) gradually implementing RMB payment for in-bound direct investment transactions;

(5) gradually implementing RMB financing for overseas projects;

(6) bringing into full play the advantages of the settlement model for Shanghai agent banks, and constantly expanding overseas settlement networks[3]; and

(7) continuously promoting related foreign institutions to invest in the interbank bond market, and attracting more foreign banks to invest in the [RMB] interbank bond market.

4. Impact on Foreign Investment and Related Legal Schemes

Taken as a whole, the above existing and planned pilot programmes for RMB settlement in Shanghai represent a real breakthrough in the current PRC foreign exchange regime. Although the above pilot programmes do not provide a clear timetable for the RMB to become fully convertible, they reflect significant movement towards full convertibility of the RMB. PBOC Governor Zhou Xiaochuan remarked recently at a national economic forum in Shanghai that if cross-border use of RMB hits a certain level, a natural demand will occur which will lead to a gradual and orderly movement towards full convertibility of the RMB.

Full convertibility of the RMB would greatly facilitate foreign investment in China and would result in major changes to the legal and regulatory environment. In terms of foreign investment market access, less government approvals - which are discretionary and time-consuming - would be required. Certain constraints on transaction structures due to foreign exchange controls would disappear (e.g. if a Chinese investor could pay for the acquisition of equity interests in a foreign-invested enterprise in China held by a foreign investor directly in RMB, this would avoid the often lengthy delays in obtaining SAFE approval for what is considered a capital account transaction, making Chinese buyers potentially more attractive to foreign investors).

Repatriation of funds out of China and the trapping of RMB funds in China due to foreign exchange controls remain areas of major concern for foreign investors in China, and freeing up these areas would result in a big boost to foreign investment. If full convertibility were to occur, this might mean the highly technical and complex regime governing security given by Chinese parties to foreign parties might fall away, thereby putting foreign security beneficiaries on a genuine level footing with their domestic Chinese counterparts.

Additionally, some existing schemes which provide for limited access to Chinese overseas and domestic capital markets through discretionary SAFE investment quotas such as the Qualified Foreign Institutional Investor scheme ("**QFII**") (which allows foreign investors to invest in the RMB-denominated A-share market on being approved as a QFII and obtaining an investment quota from SAFE); the Qualified Domestic Institutional Investor scheme ("**QDII**") (which allows Chinese investors to invest in overseas financial markets through a QDII on obtaining a SAFE quota); and the rules governing foreign debts (i.e. debts owned by Chinese entities to overseas individuals or entities) may need to be revised or may simply fall away. On the other hand,

[3] This refers to where cross-border RMB is converted through designated commercial banks in China who act as agents of foreign banks or through designated overseas banks able to receive and convert RMB.

given SAFE's continued preoccupation with "hot money", it can be anticipated that China will step up its anti-money laundering controls if further liberalisation comes about.

5. Conclusion

The pilot measures for RMB settlement of cross-border business initiated in Shanghai represent a significant breakthrough in the PRC foreign exchange regime. Shanghai seems motivated by its desire to be seen as China's leading international finance centre to take the lead with advancing the internationalisation of the RMB in a variety of contexts. Recent policy pronouncements suggest that internationalisation is part of a wider plan whose ultimate goal is full convertibility of the RMB, which will further facilitate foreign trade and investment in China. The new measures will present both opportunities and challenges to domestic and foreign investors alike, but will, in our view, prove to be extremely beneficial over time in terms of reducing foreign investor concerns about currency controls and having RMB trapped in China, whilst bolstering the role of RMB as an international payment and reserve currency; as such they represent an important milestone in the long march to full convertibility of the RMB.

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