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DOING MORE BUSINESS WITH CHINA: WHY CANADA NEEDS A RENMINBI HUB

October 2014





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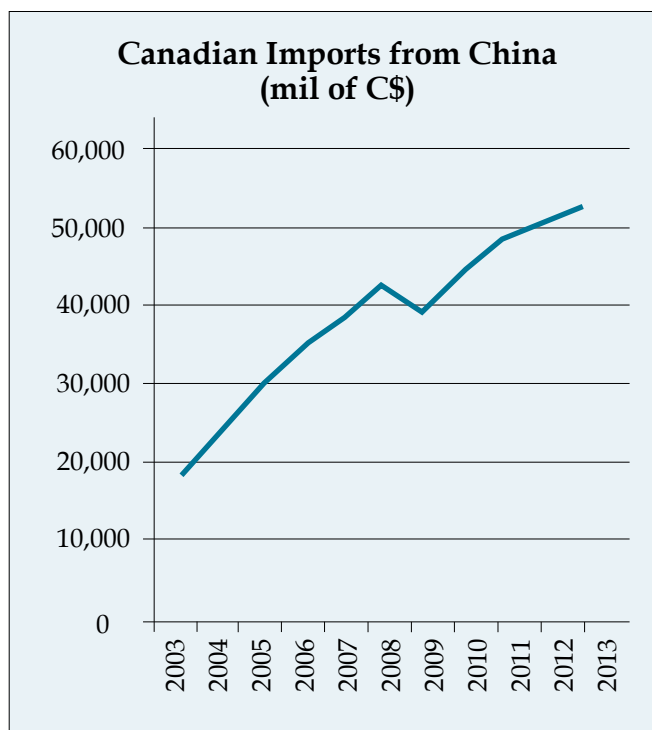
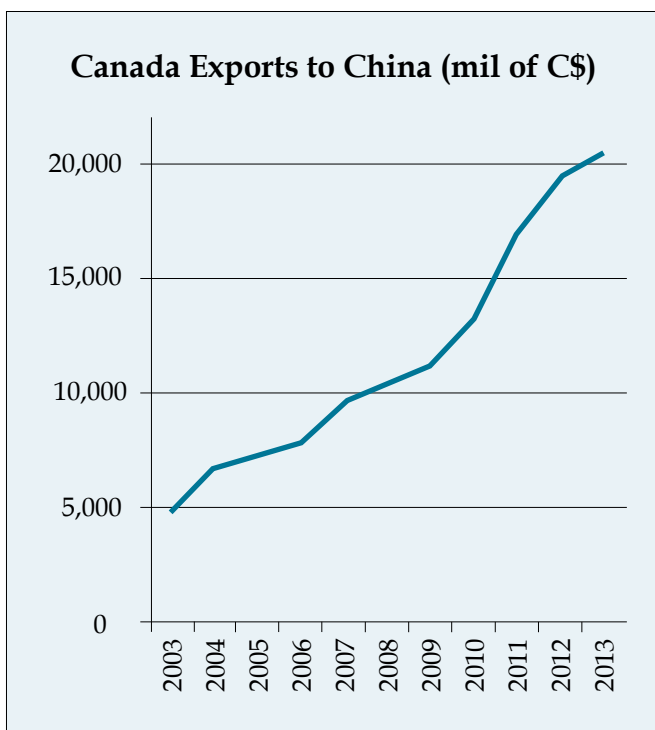
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INTRODUCTION

What if there was a way to boost trade with Canada's fastest growing export market, to take steps that would make Canada an international finance leader, a first-mover in the Americas, connecting trade and investment flows to Asia? What if we could cement our commercial and diplomatic relations with the country that will one day become the world's largest economy and facilitate our ability to do business in the world's fastest growing currency?

Over the past decade, China has become Canada's second largest and fastest growing trading partner, with exports quadrupling from \$5 billion to \$20 billion and imports nearly tripling from \$18.6 billion to \$52 billion¹. The countries complement one another, with Canada exporting so many of the natural resources that a rapidly industrializing China needs while wealthy Canada imports many consumer goods. The potential for future growth is enormous as China continues its march to become the world's largest economy.

In fact, 2013 saw China surpassing the United States to become the world's biggest trading nation, with imports and exports totaling \$4 trillion. At the same time, the use of China's currency, the renminbi (RMB) is growing by leaps and bounds in trade finance, from just 1.9% of global activity in January 2012 to 8.7% at the end of 2013². The renminbi is the world's second most often used currency, and China's government is keen to liberalize the renminbi and ensure an increasing share of trade flows is denominated in the currency. This has created a unique, once in a generation opportunity for Canada's businesses and banks to leap ahead of competitors and become early adopters of RMB, currently the world's fastest growing currency. It is time to take the relationship to the next level by establishing a renminbi trading hub in Canada.



1 Statistics Canada via Trade Data Online. Can be viewed at www.ic.gc.ca/tdo

2 SWIFT. "RMB now 2nd most used currency in trade finance, overtaking the Euro": http://www.swift.com/about_swift/shownews?param_dcr=news.data/en/swift_com/2013/PR_RMB_nov.xml#sthash.7B2wLZzU.dpuf

WHAT IS A RENMINBI TRADING HUB?

It is a centre that is authorized by China's central bank to complete RMB transactions, with the financial infrastructure for settlement and clearing and with sufficient liquidity to handle large transactions at a stable and predictable exchange rate.

Typically, this involves setting up the necessary financial infrastructure, which includes a central bank swap line, a clearing bank, investment licences/quotas and other clearing/trading elements as well as active marketing by the private and public sectors. In recent months, the People's Bank of China has approved RMB-clearing banks in centres such as London, Frankfurt and Seoul and has signed agreements with Paris and Luxembourg. Also, 25 other countries have signed currency swap agreements with China so far³. It is becoming a crowded field but as yet there are no countries in the Americas that boast RMB trading hubs. A quick-moving Canada could be the first, giving us a significant competitive advantage.

The federal government has an important role to play in leading the negotiations with China and in setting up the infrastructure, but Canada's private sector will play a central role with the financial sector marketing the trade and investment advantages of RMB and Canada's position as a hub, while the extent and speed of RMB adoption will be decided by Canadian corporations generally.

Over the longer term, the internationalization of the RMB is a mega-trend that will reshape global finance and perhaps, many years from now, even challenge the supremacy of the U.S. dollar. But it could also spur reform of the Chinese system, encouraging greater efficiency and market-orientation by opening up more of China's economy to the world. It is crucial that Canadian businesses, financial institutions and investors are an integral part of this transformation.

³ Liao, Steven and McDowell, Daniel E. "Redback Rising: China's Bilateral Swap Agreements and RMB Internationalization". http://faculty.maxwell.syr.edu/dmcdowel/redback_rising_mcdowell_liao.pdf

WHAT ARE THE BENEFITS OF HAVING AN RMB HUB?

There are four key advantages to the Canadian economy that could come from the establishment of an RMB trading hub.

1. Bilateral trade would likely expand because the use of RMB will enable lower transaction costs, more favourable credit terms, discounts on imports from Chinese suppliers and rising exports as Chinese buyers express strong preference for use of their local currency.
2. Canadian capital markets could expand and diversify so that businesses can raise funds in RMB and access one of the largest pools of savings in the world. Investors could also purchase Chinese securities, seeking the gains from such a dynamic and fast-growing economy.
3. Canada's financial sector would gain a competitive advantage by being able to offer a full suite of RMB products to customers thereby generating more business and making Canada a first-mover in the Americas, connecting trade and investment flows to Asia.
4. Canada's commercial and diplomatic relations would be reinforced with the country that will one day become the world's largest economy while supporting the liberalization and opening up of China to the world.



WHAT WOULD AN RMB HUB MEAN FOR CANADIAN BUSINESS?

The main immediate benefit is a potential boost in sales and profits for Canadian companies doing business in China. There is ample evidence that Chinese companies prefer transacting in RMB. A recent survey by HSBC showed that 55% of Chinese businesses said they would offer discounts of up to 5% to their trading partners for RMB denominated transactions⁴. BNP Paribas cites discounts in the range of 1-3% for overseas corporates when dealing with Chinese companies in RMB⁵. This means many Canadian importers could save a lot of money and potentially offer lower prices to Canadian customers.

Additionally, payment terms in China that are settled in foreign currencies are usually limited to a maximum of 90 days, both for imports and exports. This is because there are additional administrative requirements from the central bank when payment terms go beyond 90 days. Settlement in RMB enables an extension of payment terms of up to 210 days. This means a Canadian importer could purchase goods and on-sell them to customers before repaying his Chinese supplier. Or conversely, a Canadian exporter could offer 210 day letter of credit terms to get the deal and then discount the LC with her Canadian bank in order to get cash right away.

At the same time, manufacturers and exporting companies whose supply chains are sourcing from China are leaving money on the table because they have not considered the benefits of paying suppliers in RMB. In addition, trading in RMB shows a commitment and depth of understanding that can improve relations with the Chinese company. In fact, nearly 2/3 of businesses in mainland China and Hong Kong think that foreign companies that do business in RMB benefit financially and build stronger trading relationships.

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Most importantly, trading in RMB can open the doors to new business. Chinese companies can more easily borrow in RMB and with the majority of Chinese companies willing to discount prices, offering to do the deal in RMB can make all the difference. Because the bulk of Canadian exports to China are in highly competitive commodities with low profit margins, such as wood products, iron ore and coal, selling these goods in RMB can give Canadian companies the edge to beat out international competition.

⁴ HSBC. "RMB Survey", <http://www.hsbc.com/news-and-insight/2013/rmb-survey>

⁵ BNP Paribas. "All About RMB - A Corporate Handbook", www.fcihk.com/files/dpt_image/5_committees/Sourcing/100114-BNPP%20RMB%20Brochure.pdf

HOW MUCH INCREASED TRADE COULD WE GAIN FROM HAVING AN RMB HUB?

The biggest advantage to using RMB is the potential for winning additional export deals due to a Chinese buyer preferring to pay in her local currency. Because of the large amount of trade with China, any increase in the growth rate would have a huge payoff. Over the past decade, Canada's exports to China have been growing at a compound annual growth rate of 11.7%.

For the purpose of gaining a rough estimate of the potential impact from expanded use of RMB by Canadian exporters, the Canadian Chamber modeled different scenarios for how much uptake there would be from Canadians, how much additional business could be won in China and how the impact would vary depending on the export sector.



Most of Canada's exports to China are global commodities, such as coal, other metals and agriculture, which are highly competitive with thin profit margins so that denominating these sales in RMB could be a significant inducement to Chinese buyers. The previously mentioned surveys show that Chinese companies express a strong preference for RMB transactions, and we know that buyer discounts can make a big difference. Thus, a Canadian company could gain a significant advantage from the ability to do RMB sales. Based on discussions with business and financial institutions, we went with the most conservative scenario, which considers a modest 10% increase in the rate of growth. In absolute terms, this means export growth would increase by just under 1% and compound going forward. In our view, this is a reasonable and conservative assumption given the overwhelming Chinese preference for RMB and given that we are assuming some first-mover advantage by Canada in the Americas. In fact, many experts thought the gains could be greater. Nevertheless, the model shows that Canada could generate an additional \$21-\$32 billion of exports over the next 10 years.

On the import side, it is difficult to say how many Canadian companies will start paying in RMB in order to benefit from discounts. If we look to Australia, we can see a pretty strong uptake with the value of Australia's RMB payments increasing by 248% in the first year the hub was in place, but this is from a low base and with few data points. In order to be conservative, we modeled what would happen over the next decade if the number of Canadian companies paying for their imports in RMB were to rise to 30% with roughly half of them receiving discounts in the 3% range. The incremental savings by Canadian importers would rise from \$68 million in the first year up to \$500 million in 10 years totaling about \$2.75 billion over the next 10 years.

We estimate the direct benefits of an RMB trading hub would be an additional \$21-\$32 billion of exports, plus potential discounts on imports totaling \$2.8 billion.

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WHICH SECTORS OF THE ECONOMY WOULD SEE THE GREATEST BENEFIT?

There is a broad variety of Canadian merchandise sectors that export to China, but those that would see the greatest benefit are industries where prices are highly competitive and set internationally. According to the Canadian businesses we spoke with, there are many commodity exports where the use of RMB could make a significant difference to a company in a competitive bid situation.

Accordingly, we modeled which sectors would see the greatest benefits from RMB based on a 10% rise in the rate of growth adjusted based on export sector characteristics.

The forestry sector came out on top with \$6.7 billion in additional exports to China over the next decade with potential gains due to the high rates of export growth as well as the tough international competition and substitutability of the product. Similarly, soybeans, wheat, iron ore and paper would also pick up multi-billion dollar gains over the coming 10 years.

| Industry | C\$ millions increase in Exports over next 10 years |
|---|---|
| 11331 - Logging | 3,398 |
| 32111 - Sawmills and Wood Preservation | 3,326 |
| 11111 - Soybean Farming | 1,800 |
| 11114 - Wheat Farming | 1,530 |
| 21221 - Iron Ore Mining | 1,496 |
| 32211 - Pulp Mills | 1,480 |
| 33641 - Aerospace Product and Parts Manufacturing | 1,255 |
| 31161 - Animal Slaughtering and Processing | 1,178 |
| 21211 - Coal Mining | 1,103 |
| 31122 - Starch and Vegetable Fat and Oil Manufacturing | 1,052 |
| 21223 - Copper, Nickel, Lead and Zinc Ore Mining | 1,018 |
| 11113 - Dry Pea and Bean Farming | 767 |
| 11293 - Fur-Bearing Animal and Rabbit Production | 674 |
| 21239 - Other Non-Metallic Mineral Mining and Quarrying | 501 |
| 32519 - Other Basic Organic Chemical Manufacturing | 394 |
| 32518 - Other Basic Inorganic Chemical Manufacturing | 361 |
| 11112 - Oilseed (except Soybean) Farming | 303 |
| 31171 - Seafood Product Preparation and Packaging | 231 |
| 33331 - Commercial and Service Industry Machinery Manufacturing | 172 |



WHICH REGIONS WOULD SEE THE GREATEST BENEFIT?

Using a similar model with historic provincial growth rates adjusted for industry mix, we see that British Columbia would see the biggest gain in exports, an additional \$9.37 billion over the next decade. Indeed, the provinces that will see the greatest gains are those that have already have strong exports to China, that export forestry, metals and other commodities and that are in industries with thin margins and prices that are often set internationally.

| Province | Increase in Exports over the next decade |
|---------------------------|--|
| British Columbia | 9,370 |
| Saskatchewan | 4,378 |
| Quebec | 2,255 |
| Alberta | 1,503 |
| Ontario | 1,070 |
| Newfoundland and Labrador | 1,067 |
| Manitoba | 1,000 |
| New Brunswick | 414 |
| Nova Scotia | 253 |
| Northwest Territories | 28 |
| Prince Edward Island | 14 |
| Nunavut | 2 |
| Yukon Territory | - |

WHY AREN'T CANADIAN COMPANIES ALREADY USING RMB?

The HSBC survey showed that Canadian companies lagged their foreign competitors. Of the 11 countries surveyed, Canadian companies were the least likely to use RMB. Just 5% said they had conducted transactions in the Chinese currency compared to 22% of companies worldwide and 17% of U.S. companies⁶. Why are RMB transactions so rare in Canada? Currently, the use of RMB is costly, it involves a high level of administrative burden and it is very difficult to hedge exposures. RMB commercial savings accounts only became available in Canada in 2012, and when asked why they are not using the currency, the primary reason cited was lack of awareness of the benefits or that they hadn't fully considered it.

Based on our discussions with businesses and financial institutions, it is very likely that far more Canadian companies would denominate their trade transactions in RMB if these services were cheaply and easily available in Canada. The financial institutions acknowledge that they would have to play a central role in marketing the potential benefits to their clients.



⁶ HSBC. "RMB Survey", www.hsbc.com/news-and-insight/2013/rmb-survey

WHAT DOES THE TRADING HUB MEAN FOR THE CANADIAN FINANCIAL SECTOR?

The ability to directly convert RMB to CAD (without USD) could save Canadian companies \$6.2 billion over the next decade.

Most Canadian financial sector members told us the number one reason they need an RMB trading hub is so they can better serve their customers. They want to offer a complete suite of RMB product offerings that can be customized to the client's specific needs, whether it is trade finance, contract bonding, chequing accounts, short-term liquidity or long-term financing. The long-term potential is huge, and Canadian companies need improved access to RMB services. In 2013, about 10.5% of China's global trade, over \$400 billion, was settled in RMB, and HSBC forecasts that could rise to 30% or about \$2 trillion by 2015⁷. All of the data and surveys confirm that RMB use is growing among international competitors.

The RMB hub would also give Canadian financial institutions an important advantage in being able to offer a complete suite of RMB services to customers throughout the U.S. and Latin America.

The RMB hub would enable the Canadian financial sector to quickly and efficiently clear and settle transactions here in Canada without going through subsidiaries in London or Singapore. In fact, just being able to convert directly from Canadian dollars to RMB, instead of going through an intermediate conversion into U.S. dollars, could save a company approximately 1.03% on the transaction⁸. One per cent may not sound like much, but it would amount to \$730 million in foreign exchange savings on \$73.2 billion of trade last year. Even if we assume that half of these potential savings would be lost to competitive pricing or to fluctuations in the RMB/CAD exchange rate, it would still amount to \$6.2 billion in savings over the next decade, real cash in the pockets of Canadian companies.

The RMB hub would also give Canadian financial institutions an important advantage in being able to offer a complete suite of RMB services to customers throughout the U.S. and Latin America.

⁷ Clennam, Arthur. "Tackling Renminbi Trade", Global Finance Magazine, www.gfmag.com/magazine/june-2013/tackling-renminbi-trade

⁸ MMK Consulting. "Potential Benefits of a Canadian-Based RMB Settlement Centre", Sept. 2014.

WHAT ABOUT CANADIAN CAPITAL MARKETS?

China is not just a trading nation, it also has some of the highest savings rates in the world and there is a huge appetite for RMB denominated investments. In 2013, offshore renminbi deposits amounted to 1.6 trillion, an incredible pool of funds that Canadian companies or even governments can tap into. In fact, 2013 saw the province of British Columbia become the first foreign government to issue bonds in Chinese renminbi and the issue was quickly oversubscribed. Federal crown corporation Export Development Canada also issued an RMB 100 million bond in July of last year.

A Canadian business building a plant in China or with parts of its supply chain in China could more cheaply raise funds by issuing RMB bonds. Canadian investors would also have the opportunity to buy Chinese securities. China's capital account remains closed and the total amount of foreign investment in China's capital markets is quite small at 1 trillion renminbi (US\$160 billion), but China is slowly opening its domestic capital markets and there could be huge opportunities for Canadian investors to diversify their portfolios and garner the returns from one of the world's fastest-growing economies.



Finally, Canadian banks could offer these services to their customers throughout the Americas. A Canadian financial institution could issue RMB bonds on behalf of its American clients or become the lead arranger of bond issuances for companies in Chile and Brazil that source from China. Canadian banks would have a significant first mover advantage in the Americas, potentially capturing the market for RMB in the U.S. and Latin America.

CONCLUSION

For the foreseeable future, the U.S. dollar will remain the world's reserve currency and the global leader in trade and investment. But diversification is a reality, and the RMB hub has enormous potential benefits, particularly for such a low-cost, low-risk way to boost economic linkages with China.

In a competitive global environment, every advantage counts, and Canadian companies cannot be left behind. There is simply no time to waste because the benefits could be enormous: more than \$30 billion in direct trade benefits, a more competitive financial sector, more investment in Canada and solidified commercial and diplomatic relations with the country that will soon be the world's largest economy.



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