

Best Practices Series

# Managing Currency Risk in the Chinese Market

**WRITTEN BY:**

Mark Noble  
Senior Foreign Exchange Trader  
408.654.7711  
[mnoble@svb.com](mailto:mnoble@svb.com)

To compete in an increasingly global economy, technology and life sciences companies must pursue opportunities wherever they emerge around the world. CFOs across the U.S. are signing contracts to enter the fast-growing market of China. Access to global capital, well-educated and low-cost labor, outsourcing opportunities and a large untapped consumer base are all part of the appeal.

Whether management intends to open a sales office, buy computers or outsource IT support, an overseas strategy can propel a company to the head of its class. But it can just as easily send the business into a financial tailspin. Succeeding in China requires understanding its unique government and currency — and taking proactive steps to offset the financial exposure of doing business there.

**GOVERNMENT CONTROL**

Given its massive size, the foreign exchange (FX) market in China is unusual as the government tightly controls the flow of money in and out of the country. Any number of events — such as an election, a natural disaster, or a new five-year plan — can put even a well-executed investment at risk.

The first step when considering a deal in China is to become familiar with the regulatory framework and unique characteristics of the market. An important arm of China's central government, the State Administration for Foreign Exchange (SAFE), regulates foreign exchange controls and currently prohibits offshore conversion of the yuan (CNY). The central bank, known as the People's Bank of China (PBoC), implements monetary policies and oversees the

stability of its financial system. It routinely targets 10 percent GDP growth each year and has historically kept the currency artificially weak to achieve that goal. At the highest level, the State Council of the People's Republic of China supervises both of these government entities.

On July 21, 2005, China reversed its policy of pegging the yuan solely to the U.S. dollar and allowed it to fluctuate versus a basket of currencies. The USD/CNY rate increased approximately 2 percent, from 8.28 to 8.11 on that day, and daily fluctuation in the USD/CNY was agreed to be limited to +/-0.3 percent of the previous day's closing rate. In an effort to even out trade imbalances with the U.S., the government also instituted a policy of stair-step appreciation of the currency, resulting in a 16 percent appreciation from July 2005 to July 2008. Since July 2008, the PBoC has halted its currency's appreciation in an attempt to aid local exporters impacted by the global credit crisis.

Prior to July 2008, currency appreciation of USD/CNY meant contracts and payments negotiated in the past were getting more expensive to fulfill — to the tune of 7 to 12 percent per year. If you are new to the Chinese market, you may be worried about sending funds into China to make payroll or cover costs for services and supplies. Even if you already have experience doing business in China, you may struggle to find the right foreign exchange solution due to the specific, localized nature of the challenges.

Work closely with your accountants, senior management and other finance team members to ensure that the strategy you select is appropriate for your company, especially since different hedging products have different cost-benefit profiles. Making sure the cost for the approved strategy matches your company's risk-reward objectives in your foreign exchange policy is, of course, vital as well.

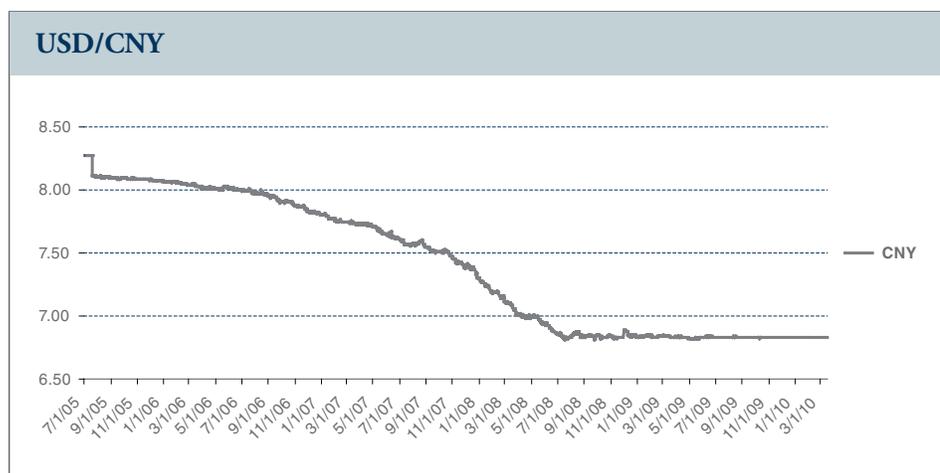
### LOOK BEFORE YOU LEAP

What are the implications of this complex environment for U.S.-based companies? First, because offshore banks cannot deliver the currency via deliverable forward contracts, hedging tools are limited to non-deliverable forwards (NDFs), which must be settled in U.S. dollar (or another convertible currency) equivalents. A non-deliverable option market (NDO) also exists and is settled in U.S. dollars as well. Second, rising inflation in China has recently been partially responsible for the currency appreciation, and may lead to further uncertain policy responses going forward. For example, an aggressive PBoC tightening policy could bring domestic growth to an abrupt halt and result in millions of Chinese workers losing their jobs; however, China's political leadership is unlikely to let such a drastic scenario take place.

There are no easy answers, but a number of foreign exchange tools and strategies do provide effective solutions. An experienced foreign exchange advisor can help you keep up with the rapid pace of change and devise a viable strategy to offset the financial exposure of your Chinese operations.

### A MENU OF OPTIONS

Given the restrictions and constantly changing policies in this otherwise attractive market, what can technology and life sciences companies do today to offset their foreign exchange exposure? Available tools include:



Source: Bloomberg, Silicon Valley Bank

- **Non-deliverable forward (NDF)**  
A forward foreign exchange transaction in which the net settlement is made in a non-restricted, convertible currency. Generally, liquidity is good up to one year, but decreases for longer maturities, which can sometimes impact pricing and could make it difficult to exit the hedge if necessary.
- **Non-deliverable option (NDO)**  
May or may not require the payment of an upfront premium, but could provide flexibility to convert at better levels, while offering an insurance policy against a negative

movement of the currency.

- **Currency linked deposit**  
Provides a vehicle for expressing a view on exchange rates: returns are higher if the view proves correct and are lower or non-existent if the view is wrong. Typically, the principal is protected in these structures.
- **In-country loan**  
Involves setting up a local currency (CNY) loan to offset a local currency asset.
- **In-country account**  
Requires placing money in an interest-bearing local currency account to fund payables; be sure

to compare the interest rate on the deposit to the implied rate in the NDF.

- **In-country deliverable forward**  
Involves entering into a regular forward contract with a domestic bank. Rates may be aligned with the offshore (NDF) market or may differ. This tool will often require that the local subsidiary establish a line of credit with a local bank, which may or may not be feasible.

CFOs that deploy these tools should seek to establish hedges that match the duration of their underlying asset or liability. When shorter duration hedges are used, cash flow risks may

### Top Five Myths about Doing Business in China

#### MYTH

#### FACT

1 There is no way to control costs of doing business in China.

Solutions are imperfect and constantly changing, but CFOs do have options today.

2 The same foreign exchange tools you use in Europe work in emerging markets like China.

Centrally regulated, illiquid currencies require a different approach and only certain foreign exchange tools can be applied.

3 You cannot hedge the CNY.

The currency has restrictions but it is possible to hedge it.

4 Large offshore banks can deliver CNY to China.

No offshore bank can deliver the currency.

5 If I am invoiced in U.S. dollars for payables, then I have no foreign exchange exposure.

A vendor or service provider based in China will convert its local costs into U.S. dollars at the time of invoicing, so the dollar value will fluctuate with the exchange rate. As a result, U.S. dollar invoicing might obscure but will not eliminate foreign exchange exposure.

**NDFs in Action***Using NDF contracts to hedge future Chinese yuan payments*

- **CNY Appreciation risk:** A company expects to pay 10 million Chinese yuan (CNY) six months from today for equipment purchases. Concerned about further CNY appreciation, the CFO of the company hedges potential CNY risk by entering into an NDF contract with SVB.
- **NDF contract:** The company buys CNY six months forward (sells USD) from SVB at the current six-month NDF rate of CNY 6.7200 per U.S. dollar.
- **Net settlement:** At the end of six months, USD/CNY exchange rate at the official fixing has three possible outcomes: It can be at par, higher (CNY depreciates) or lower (CNY appreciates) than the contracted NDF rate of 6.7200, resulting in no gain/loss, net inflow or net outflow USD settlement.

come into play, as hedges expire at their original contract rate but are closed out at the official fixing, potentially resulting in large swings in USD cash flows for the company. Moreover, entering into forwards or selling options creates a credit exposure for any bank, which can be secured through cash or by using a portion of a previously established credit facility.

In addition to these financial tools, CFOs may consider a number of non-financial ways to hedge, such as leading and lagging or moving an administrative office from China to Hong Kong, where the currency is convertible and costs could be less.

Finally, it's impossible to make foreign exchange decisions to protect investments in China without considering market projections and one's own view of the future. For example, the CNY appreciated at an annualized 15 percent from

December 2007 to June 2008; however, the current forward market pricing implies only a 3 percent annual appreciation going forward. A CFO who believes the previous 15 percent will again be the norm may find it more attractive to use NDFs to hedge the company's payables.

**DON'T GET CAUGHT BY SURPRISE**

The complex, rapidly-changing regulatory framework in China requires education and constant monitoring. The volatile, illiquid currency market can mean contracts can end up costing much more than agreed-upon amounts. This high degree of foreign exchange exposure often catches management by surprise. It's important to learn about these financial markets and tools for mitigating foreign exchange exposure before you make a firm commitment to proceed.

From a forecasting point of view, the CNY is expected to continue

appreciating for the foreseeable future, though the rate of appreciation is expected to fluctuate.

All U.S. banks face the same challenges in China and share the same fundamental hedging tools. That's why when venturing into any emerging market, it's important to choose a foreign exchange services partner that has deep experience in your industry as well as a strong understanding of the markets and currencies in which you'll be doing business.

The solutions for hedging foreign exchange exposure may not be perfect today; however, as many companies have discovered, with a knowledgeable advisor and a little creativity, it is possible to put an effective strategy in place. An experienced foreign exchange advisor can help you keep up with the rapid pace of change and devise a viable strategy to offset the financial exposure of your operations in China.

**Market Overview: China\***

<b>Currency</b>	Chinese Renminbi (RMB) or Yuan (CNY)
<b>Size of Economy</b>	\$4.9 trillion (Largest in emerging Asia, just behind Japan in USD terms)
<b>GDP Growth Rate 2009</b>	8.7%
<b>Foreign Exchange Reserves</b>	\$2399 billion
<b>Regulatory Framework</b>	State Council of the People's Republic of China (Central People's Government) supervises both the State Administration for Foreign Exchange (SAFE) and the People's Bank of China (PBoC).
<b>Exchange Rate Change 2009</b>	None; CNY remained unchanged at 6.8270 vs. USD
<b>Regime</b>	Managed float
<b>Trade Against</b>	USD
<b>Average Daily Volume</b>	\$1.2 billion (offshore NDF market)
<b>Onshore Forward Market</b>	Deliverable; restricted mainly to domestic corporates and scrutinized closely
<b>Offshore Forward Market</b>	NDF (non-deliverable forward); SVB's clients typically hedge up to 12 month maturities. Longer maturities are available, but liquidity is sharply reduced.
<b>Fixing</b>	The People's Bank of China (PBoC) Fix 9:15 am Beijing time Two business days Fixing Conversion
<b>Reuters Fixing Page</b>	SAEC
<b>FX Options</b>	Yes, NDO (non-deliverable option) settles against NDF fixing, not against spot. Typical trades up to one year, longer maturities possible but not liquid. Call for other maturities.
<b>Onshore Spot</b>	Only licensed onshore counterparties are allowed. CNY spot can currently only be traded against USD, HKD, EUR and JPY on CFETS, China's inter-bank FX trading system, conditional on submission of the required documentation. Certain kinds of conversions under non-trade and capital items require pre-approval from SAFE.
<b>Offshore Spot</b>	Restricted to all offshore banks and participants

\* As of March 17, 2010.

## About Silicon Valley Bank

About Silicon Valley Bank Silicon Valley Bank is the premier commercial bank for companies in the technology, life science, venture capital/private equity and premium wine industries. SVB provides a comprehensive suite of financing solutions, treasury management, corporate investment and international banking services to its clients worldwide. Through its focus on specialized markets and extensive knowledge of the people and business issues driving them, Silicon Valley Bank provides a level of service and partnership that measurably impacts its clients' success. Founded in 1983 and headquartered in Santa Clara, Calif., the company serves clients around the world through 27 U.S. offices and international operations in China, India, Israel and the United Kingdom. Silicon Valley Bank is a member of global financial services firm SVB Financial Group (Nasdaq: SIVB), with SVB Analytics, SVB Capital, SVB Global and SVB Private Client Services. More information on the company can be found at [www.svb.com](http://www.svb.com).

SVB *Find a way*

SVB Financial Group

**Silicon Valley Bank Headquarters**

3003 Tasman Drive Santa Clara, California 95054 U.S.A.

Phone 408.654.7400 [svb.com](http://svb.com)

Foreign exchange transactions can be highly risky, and losses may occur in short periods of time if there is an adverse movement of exchange rates. Exchange rates can be highly volatile and are impacted by numerous economic, political and social factors, as well as supply and demand and governmental intervention, control and adjustments. Investments in financial instruments carry significant risk, including the possible loss of the principal amount invested. Before entering any foreign exchange transaction, you should obtain advice from your own tax, financial, legal and other advisors, and only make investment decisions on the basis of your own objectives, experience and resources. Opinions expressed are our opinions as of the date of this content only. The material is based upon information which we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon as such.