

The Changing Face of China Trade and Finance

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China trade has been flourishing these days. The total value of the PRC's imports and exports has been increasing by more than 20% annually since 2001. The total trade value was \$851 bn in 2003, accounting for approximately 5% of the world's total, ranking the 5th largest in the world. Its total trade value in the first seven months of 2004 amounted to \$623 bn, increasing by 38% year on year. For the first time since 1994, the PRC's trade balance registered a deficit of \$4.8 bn as of the end of July 2004. Its major trading partners are the U.S., Japan, the rest of Southeast Asia, and the EU. Its trade surplus with the U.S and EU is offset by its trade deficit with Japan and other Asian trading partners. Approximately 22% of its imports are primary products including mining products and raw materials. China's demand for machinery and equipment, computers, crude oil and metals as well as grain and soybeans has exerted a major impact on trade in Asia and is reshaping international trade relations.

One key driving force for the fast trade growth is the strong performance of the PRC economy, with GDP growth at 9.1% in 2003 and 9.7% in the first half of 2004. IMF predicts that the PRC economy will grow by 9% in 2004 and 7.5% in 2005. The second driving force is the increase in the world's commodity prices. The PRC has become a major buyer in the world's commodity markets. For instance, it became the second largest oil consumer and the third largest crude oil importer in the world in 2003. The economic resurgence has strained supplies of raw materials, causing price hikes and shortage of electricity. Since April this year, the government has instituted administra-

tive measures to curb excessive investment in certain sectors such as steel, aluminum, and real estate. This has already achieved certain results as the industrial production slowed down in July. However, it may take a few years for the economy to truly cool off, as the previous economic surge which started in 1992 did not bottom out until 1999. It is expected that the PRC economy will continue to grow at an average rate of 7% before the end of this decade.

China trade is booming and changing, and so is the way it is financed. Foreign banks have become major players in providing trade finance services, and new structured finance transactions have also taken place in recent years.

Foreign banks have spearheaded innovations in trade finance in the Chinese market since they followed their clients into mainland China in the early 1980s. They have established a stronghold in the local market ever since, boasting 199 operating offices as of June 2004. They provide a range of trade service products including L/Cs, D/P, D/A, forfeiting and factoring. Ninety seven foreign banks are now allowed to conduct business in RMB, the local currency. With the PRC's WTO membership in December 2001, foreign banks are now permitted to own less than 25% of local financial institutions. A number of international financial institutions have already invested in 6 local financial institutions as of June 2004, further strengthening their influence in the local market.

One major breakthrough made by foreign banks is structured commodity finance. A number of international banks have arranged cross-border

structured commodity finance transactions involving aluminum, coking coal, and even frozen fish. Fortis Bank, for example, arranged a 1-year coking coal prepayment financing transaction in 2003. The borrower, a trading company based in Singapore, is the off-taker of the coking coal to be produced by a local coal company in Shanxi province, a major coal producing area in northern China. The proceeds of the loan were used by the coal producer for producing coking coal to be exported to the Singapore-based purchaser.

Another landmark development in trade finance is export financing by foreign banks with cover from Chinese ECAs. For instance, SG EIB and the state bank ICBC made a 5-year \$40 million loan to Algerian Telecom with political risk cover from Sinasure, a Chinese ECA. The proceeds were used to finance purchase of telecom equipment from a Chinese telecom equipment manufacturer based in Shenzhen.

Other inroads made by foreign banks in China are in the project finance and related trade finance services. Foreign banks were the major lenders to foreign-funded enterprises and infrastructure projects including highways and power plants in the 1990s. Foreign banks made their loans to infrastructure projects with ECA political risk cover from major OECD countries. In the past few years, foreign bank participation in project financing has been very limited and decreasing due to competition from domestic banks with excess liquidity in a very low interest rate environment. However, international banks are still the dominant players in providing project finance advisory services due to their structuring expertise.

See FACE on page 5

FACE from page 4

Domestic banks, which dominate the Chinese trade finance market, have also made contributions to new trade finance techniques. In particular, the 11 new commercial banks established in the past two decades have demonstrated their improved ability to price risks and creativity in providing innovative trade finance products. For example, the Shenzhen-based China Merchants Bank, the leader of the new commercial banks, has designed a new structure to finance commodity deals which usually involve the bank, an importing company, an oil storage facility and final users. In the traditional approach, the bank requires the importing company to provide full col-

lateral or third party guarantee as a pre-condition for issuing L/Cs, which places excessive burden on the importing companies. The new structure allows the bank to issue L/Cs on behalf of the importing company by solely relying on a 15% to 30% margin deposit and a pledge of the oil products to be imported. The bank will make payments on behalf of the importer once the conditions set in the L/Cs are met. By making payments under the L/Cs, the bank makes a loan to the importer, which is to be repaid by the proceeds from the sale of the oil imported products. The bank holds title to the imported oil products through agreement with a specific oil storage facility and the importing com-

pany, and will not release the title until cash payments by final users are received by the bank. The final users are directed by the oil importing company to pay directly into its account with the bank through an agreement between the bank, the importing company and the final users. The bank takes the risk of price decline of the imported products, which is mitigated by the margin deposit. This structure also applies to other commodity trade deals such as aluminum, copper, soy beans, etc. Such an innovation has proven very successful for the bank to attract a large number of importing companies as customers. ■

Brave New World Features Same Old Political Risks

Stephen Kay, AIG Global Trade & Political Risk Ins. Company

With today's global media coverage, it seems political risk is everywhere. Pick up a newspaper on any given day, and you might read about Middle Eastern conflicts, protests against economic liberalization in Latin America, or various governments around the globe on the brink of debt default.

Companies operating around the world can be exposed to significant, unanticipated difficulties emanating from these and other types of political risks. America's legal system offers investors an objective and relatively predictable venue for seeking recourse should things go awry. This may not be the case elsewhere, leading to unpaid contracts, or total loss of assets or investments with little hope for recoveries. Overseas opportunities can be considerable, but if such risks exist even at home, how can companies feel secure enough in emerging markets?

While it may seem exotic, political

risk, which involves company exposure to property, liability, or net income related losses, is an exposure to be assessed, managed and potentially insured just like any other. For example, assets could be destroyed or expropriated; unpaid invoices could impact cash flows and net profit; higher borrowing costs may result from lenders' perceptions of additional risk due to overseas exposures; and company officers could be held responsible for not taking reasonable measures to protect the organization from unanticipated losses. While political risk losses tend to be of lower frequency than, for example, property or casualty losses, the severity of political risk losses can be very high and should therefore be carefully assessed. How to go about assessing political risk?

Political events giving rise to such exposures can come about suddenly, or occur gradually over time. Either way, events are often very difficult to predict

in terms of both probability of occurrence, and severity of loss on an investment or trade transaction. Nevertheless, the organization should consider the political risk factors before significant resources are committed, in the context of the nature of the transaction which itself influences these potential probabilities and severities.

Political events can emanate from sources that may be quite localized, or more global in nature. Local issues leading to political upheaval could include privatization of sectors such as roads and water — necessities many people think should be provided for free, rather than paid services provided by the private sector. Another local issue might be a persistent or increasing gap between rich and poor, which may lead to resentment and eventually a popular uprising. National or international issues may include change in government through democratic elec-

See BRAVE on page 9