Brother, can you spare a jiao?

The recent downgrading of Standard & Poor's credit rating of the USA and the revelation that Apple has greater cash reserves than the US Government dispels any doubt that we will need to look East rather than West for the power to pull us out of the deepest recession since the Great Depression of the 1930's. The Office of National Statistics (ONS) reported that total goods imports from China to the UK in 2009 equalled the total from the USA for the first time; in 2010 Chinese imports increased by 25%, easily overtaking the US figure. While UK goods exports to the People's Republic are still running at a much lower level than imports, they increased by over 40% in 2010.

So, is it time we started talking in terms of yuans and jiaos rather than dollars and dimes? Well, probably not quite yet. Apart from anything else the renminbi (RMB), the official name for the yuan or "people's currency", is probably not yet sufficiently stable and easily tradable to take over from the dollar as the universal currency. Banking reform over the past 20 years has resulted in the five main Chinese state-owned banks and many of the smaller institutions being 25% owned by overseas banks. However all international RMB transactions are still processed through a single clearing bank in Hong Kong. So it's likely to be a while before the yuan is as ubiquitous as the dollar.

That said, with the seismic shift in global markets, it's probably a good time for all UK financial institutions to review their capabilities in terms of international trade finance and their readiness to ramp up and extend their operations when the world does start to come out of the other end of the tunnel. In 2010, exports from the UK totalled £266bn, with £363bn of imports. Taking into account transactions within and between huge international conglomerates and transactions funded and underwritten directly by governments, around 80% of the total £629bn UK exports and imports involved some form of credit, insurance or guarantee issued by a bank. That's £500bn per annum – trade finance really does make the world go round.

The principles of trade finance are quite simple – a supplier wants to deal with a customer, which in effect means that the supplier's bank needs to deal with the customer's bank. Trade finance consists of the mechanisms and instruments to make this happen. Within a country this is trivial nowadays; across national boundaries and trading zones it gets a bit more complicated. Importing involves primarily trade loans and stock finance; exporting may require factoring, invoice discounting and forfaiting. Imports and exports are both likely to require the use of Letters of Credit, largely unchanged in principle since they came into common usage 500 years ago.

While setting up the bank-to-bank financial components of trade finance can be complex, particularly in emerging markets such as China, relatively speaking this is the easy part. The tricky bit comes when you want to extend your commercial offerings to include more direct support for the various components of the import-export supply chain. This is where you may have greater visibility of raw materials producers, manufacturers and shippers – and will probably need to delve into the sometimes slightly shady world of local agents, the fixers who make things happen. You could steer clear of this but your customers are likely to value the service and if you don't provide it someone else will, and probably take the underlying finance and perhaps all your customer's other banking requirements as well.

Regardless of how deeply you choose to dive into the business of customers who import and export from beyond the western economies, you will need to be a little more aware of how the finance you provide is spent than would be the case in trading closer to home. You want to avoid the situation where the first you know about child labour in a sweatshop you've financed or workers being exposed to dangerous chemicals is when you see the exposé on Panorama.

At the end of the day you get to choose where you want to operate in the market. Players range from major banks providing full end-to-end capability, integrated within a broader transaction banking offering, to niche companies with 50 or so employees acting as agents or brokers, pulling together all the pieces including the underlying finance. Whatever you choose, you need to make sure you don't let the opportunities slip away from you through lack of preparation. In 2007 there were almost 9,000 recognised financial institutions operating in China with the five main state-owned banks alone employing 1.5 million people. As we emerge from the recession, providing finance through all these institutions will increase apace and you need to make sure you don't miss the boat – even a slow one.

©2011 Challenge Consulting Ltd

Click here to view more articles