

Is the Yuan about to go global?

Friedrich Wu, Pan Rongfang And Wang Di
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Not quite yet - China is in no position to challenge the pre-eminent role of the US dollar in the near future

With the rapid economic ascent of China in the new millennium, the explosion of the global crisis in 2008-09 and the consequent discrediting of the US and European financial models, as well as recent new policy initiatives adopted by Beijing towards its own currency, there have been growing debates and speculations on the future role of the yuan.

These have been further fuelled by senior officials of the People's Bank of China (PBOC), who have recently become increasingly vocal in world forums on the need for other economies to rely less on the US dollar as a reserve currency and trade settlement.

It is now commonly understood that for a currency to gain international stature, there must be strong demand by world traders, investors, and central bankers for the currency as, respectively, a medium of exchange for foreign trade settlement, a unit of account for denominating international financial transactions, and a store of value for central banks' foreign exchange reserves.

Economists generally agree that the three key economic pillars that are required to support the internationalisation of a currency are the size of an economy and its trade volume; the breadth, depth and liquidity of its capital markets; and the currency's stability and convertibility.

In terms of economic strength, with breakneck growth rates since the beginning of the 21st century, China managed to surpass the UK and Germany, respectively, in 2005 and 2007 to become the world's third largest economy. Goldman Sachs has projected that China will overtake the US to become the world's largest economy by 2027, should China manage to continue to grow at its current rate.

Far behind

However, a large GDP is not necessarily equal to a wealthy or healthy economy. Despite its No 3 world ranking in absolute economic size, China remains far behind the other leading economies in terms of average per capita income. In the long run, even though China's GDP per capita is projected to surge exponentially to US\$49,650 by 2050 from US\$2,432 in 2007, it will still lag far behind that of the US (US\$91,683) and many other developed and emerging economies, according to Goldman Sachs.

Furthermore, despite optimistic projections of China's future growth potential, its economy is still beset by numerous imbalances and risks in the medium term. These include, among various things, persistent and even widening regional economic disparity and rural-urban income inequality, rising social unrest and inter-ethnic conflicts, rampant corruption, and serious environmental degradation.

An eruption of any one of these, or a combination of several, 'fault lines' could put a

sharp brake on the ascent of the Chinese economy and concomitantly propel the yuan on to an inordinately volatile trajectory.

In terms of trade volume as a share of the world total, China's ratio was 5.1 per cent in 2007, and had already overtaken Japan and the UK in 2004. In the first half of 2009, the World Trade Organization (WTO) reported that China had surpassed Germany to become the second largest exporting nation in the world.

Accompanying the surging foreign trade is the expanding trade settlement by the yuan, which has already evolved into a major currency for cross-border trade settlement with neighbouring countries such as Vietnam, Cambodia, Russia and Mongolia. At the end of 2008, the Chinese government announced pilot programmes allowing Guangdong Province and Yangtze River Delta to use the yuan to settle trade deals with Hong Kong and Macao.

A similar arrangement has been proposed to allow Guangxi and Yunnan Provinces to use the yuan to settle trade accounts with selected Asean countries. Another recent and significant step is the announcement by the State Council that five trial cities - Shanghai, Guangzhou, Shenzhen, Zhuhai and Dongguan - are designated to spearhead international trade settlement in the yuan with overseas counterparties.

Moreover, in order to mitigate exchange-rate risks arising from trade settlement in the dollar, China has entered into bilateral currency-swap agreements with a number of trading partners. Since last December, PBOC has signed a total of 650 billion yuan (S\$135 billion) worth of currency-swap agreements with Hong Kong, South Korea, Indonesia, Malaysia, Argentina and Belarus. In addition, PBOC is still in talks with other central banks to ink additional swap agreements, and is likely to expand them to cover all of the country's trade with Asia, excluding Japan.

Liberalisation

Such recent progress signals that the Chinese government is beginning to set the yuan on a liberalisation path, starting with a gentle push of the unit to raise its profile as a medium of exchange in its regional backyard.

Aside from innate economic strength, the home country of an international currency should offer open and sophisticated transaction venues where foreign dealers can trade a range of the currency-denominated financial products, while at the same time put in place regulatory and macroeconomic safeguards to minimise the unit's volatility and exchange-rate-related risk.

Compared to other more developed capital markets elsewhere, it is clear that China's capital markets are still at an early stage and may take one to two decades to develop into comparable breadth and depth. By global standards, China has lower equity and bond market capitalisations to GDP ratios relative to those of issuing countries of major currencies.

Furthermore, despite a banking sector as large as 9.1 per cent of total global bank assets, China's equity and bond market capitalisations make up only 5.9 per cent and 2.4 per cent of the world's equity and bond markets respectively, according to Deutsche Bank Research.

Second, due to regulatory barriers on access to China's capital markets, the latter's

interaction with foreign markets and openness to the rest of the world are still very restricted. In terms of inward portfolio investments to China, the average amount between 2003 and 2007 represented a mere 0.7 per cent of total portfolio investments globally. As at mid 2009, only 87 foreign financial entities were entitled to QFII (qualified foreign institutional investor) status, which allows them to trade A-shares on secondary markets with an aggregate limit of US\$30 billion, or just 1-2 per cent of the Shanghai exchange's market capitalisation. Furthermore, the purchase of B-shares is also limited to a selected group of foreign institutional investors, and Hong Kong-listed H-shares are but a fraction of the two mainland markets.

Third, low efficiency, high transaction costs, weak supervisory and regulatory frameworks have been major constraints to the integration between China's capital markets and the international financial system. As for equity issuance, China still practises a merit-based approval system in comparison to registration-based systems in most mature capital markets overseas. According to a comparison of financial transaction costs done by the China Securities Regulatory Commission (CSRC), the Shanghai and Shenzhen stock exchanges have an average basis point of 50 (20 as average commission and 30 as transaction fee), which is much higher than the average of 21 in most mature markets. As for bond transaction costs, China has an average basis point of 6.3, dwarfing 1.0 in the UK, South Korea, India and Singapore, 0.4 in the US and 0.5 in Japan.

In view of the increasing competitiveness among world financial markets, the current bureaucratic supervisory system in China needs to be reformed to a more professional framework by international standards, and transaction costs also need to be reduced substantially.

Nevertheless, some progressive steps have been initiated recently to add more breadth and depth to China's capital markets. These include regulators' latest announcements of plans to allow qualified foreign-invested firms to list on the Shanghai exchange next year, raise investment limit per QFII from US\$800 million to US\$1 billion, and approve foreign banks to issue yuan-denominated corporate bonds. Likewise, in an unprecedented move, the Ministry of Finance said this month that in order to 'promote the yuan in neighbouring countries and improve the yuan's international status', it would help establish an offshore yuan bond market by starting to sell 6 billion yuan worth of yuan-denominated sovereign bonds in Hong Kong to foreign institutional and retail investors.

Despite these encouraging moves, going forward, it will take some years before China's capital markets can successfully transit to a more open and mature stage. According to the development strategies published by CSRC in 2008, it is forecast to take roughly a decade for China to undergo 'the drive to maturity stage' and build up well developed capital markets by the end of 2020. This would render full yuan internationalisation unlikely before that timeline.

Apart from the aforementioned 'physical' factors fundamental to the internationalisation of a currency, other 'psychological' factors such as public confidence in the value of the currency also play a supporting role. Empirically, the stability of a currency can be gauged by its home economy's inflation rate, which for China averaged a very low rate of 1.1 per cent per annum during 1998-2007.

A second way of assessing currency stability can be measured by the unit's exchange

rate volatility, which can be calculated as the standard deviation of daily percentage change in the exchange rate against the International Monetary Fund's (IMF) Special Drawing Rights (SDRs).

Our calculation yields a score of 4.4 for the yuan during the same period - lower than those of the dollar (4.5), euro (5.4) and yen (8.2).

Convertibility

However, despite its low volatility, currently the yuan lacks the foremost prerequisite to become a global currency: free and full convertibility. While the yuan became convertible for trade transactions and conditionally for FDI (foreign direct investment) in 1994, it has been largely non-convertible for all portfolio capital transactions till now.

Nevertheless, recent policy initiatives taken by the government have demonstrated the likelihood of a faster pace towards capital account convertibility. According to Guo Shuqing, former head of the State Administration of Foreign Exchange, the yuan will be convertible by 2010 for about 70 per cent of the 43 capital transaction items under the IMF classification.

Looking ahead to the medium term, the yuan is likely to evolve into only a regional currency first. It is probably too optimistic to expect the yuan to become a global currency before 2020, for reasons analysed earlier. As such, China is in no position to challenge the pre-eminent role of the US dollar in the near future. In addition, out of concern for political, economic and social stability, the Chinese government has adopted an extremely cautious approach towards financial liberalisation.

Therefore, it is not a sure conclusion that the government would have the political will to push forward aggressive reforms in capital markets, even though it has recently shown some interest in using the yuan for trade settlement. Furthermore, politically, it is also not certain whether other countries would have the confidence to accept the yuan for various international uses - a currency issued by a country controlled by a communist party.

Friedrich Wu is adjunct associate professor at the S Rajaratnam School of International Studies, Nanyang Technological University, in Singapore. Pang Rongfang and Wang Di are research assistants at the same school.