

FINANCE MANAGEMENT

“WILL CHINESE YUAN BECOME THE NEXT RESERVE CURRENCY?”

PURNENDU MAITY
ANALYST,
CREDIT POINT E.COM, PUNE

EXECUTIVE SUMMARY

Sub-prime crisis, European debt crisis, Fed's QE2 policy... consequently many observers conjecture is once again rife that we are reaching the end of the era of dollar dependency. Evidently next question is where will be the safe heaven? Who will give the hope against all odds? Given the sheer size of economy and fierce growth rate spotlight is now on Chinese Yuan. In another two decade years China is set to replace the US as the world's largest economy. It is already the world's largest exporter and will soon also be the largest trading nation. Contrary to the US, the world's largest debtor, China is also a large net external creditor, only trailing Japan. A close parallelism from history in hand is that as once economically and financially ascendant Dollar has replaced British Sterling troubled by the bequest of two world wars; would this time Redback will replace the Greenback in similar way ? China is taking many incremental steps like more trade settlements in Yuan, Currency Swap, and diversification of its reserves to internationalize its currency. Along the way there are challenges of growth with right monetary policy maneuver, exchange rate stability, financial market and legal reforms which requires considerable time in coming years. While Pound, Yen are not so strong currency given their economic and financial size and structure but Euro is still in the race. Also technically speaking IMF SDR might be another viable alternative. As the world is becoming more multi-polar there is less conclusive possibility of actually Yuan becoming single monopoly reserve currency like Dollar. After next 15-20 years more probable scenario is that it will become an internationalized currency and pose as a strong

contender along with Dollar and Euro for reserve currency option.

DETERMINANTS AND PROCESS FOR BECOMING A RESERVE CURRENCY

If we look at various financial literature¹, there are several conditions fortifying a reserve currency: the size of the economy, low inflation, exchange rate stability, deep and efficient capital markets, political stability with geo-political strength. One more important factor is network externalities which explain why once a currency becomes an international currency, in a short time period it is quite implausible to lose its standing². In general, market participants would like to stick to their loyal platform as they have invested substantially over time to accumulate the knowledge of the platform. As they use it, further more market participants will find it comfortable to use that currency and it becomes more of a self-reinforcing process³ generating a positive network effect. Internationalization of a currency is a multi-stepped long-drawn-out process that involves: at first, becoming a settlement currency; next, a vehicle currency for third-party trade or foreign exchange transactions; then, a unit of account in commodity pricing; and finally acting as a reserve currency.

CHINESE YUAN INTERNATIONALIZATION POLICY STEPS AND STANCE

INCREASE USE OF YUAN IN TRADE

Since 2003, the Beijing-based State Administration of Foreign Exchange has allowed limited use of yuan in border trade in Yunnan, Heilongjiang, Guangxi, Inner Mongolia, Xinjiang, Liaoning and Jilin⁴. Banks in China began offering banking services in Yuan in 2004, including, deposits, currency exchange, remittances, debit and credit cards, and personal checking. The outstanding Yuan deposits is RMB54. 4 billion at the end of June 2009, a 348% jump from RMB12. 1 billion at the end of 2004⁵. In Dec 2008 State Council decided to launch two pilot schemes to allow selected companies to settle trade using the Yuan in place of the dollar⁶. One scheme is centered on trade between China's export engines the Pearl River Delta and Yangtze River Delta and Hong Kong and Macau. The

other scheme covers trade between Yunnan and Guangxi and the Association of Southeast Asian Nations (ASEAN). In June 2009, it was also announced that China and Brazil had reached an "initial understanding" to gradually eliminate the dollar in bilateral trade, which is estimated to reach \$40 billion in 2009⁷. A similar agreement to move toward settling bilateral trade in their respective currencies was reached earlier in the month between Beijing and Moscow⁸. In Jan 2010, China and the Association of Southeast Asian Nations (ASEAN) kicked off one of the world's largest free trade area (FTA). By 2015, it is expected that the policy of zero-tariff rate would be for 90 percent of traded goods between China and four new ASEAN members, Cambodia, Laos, Myanmar and Vietnam⁹. As of Sept 2010, cross-border Yuan trade settlement has reached 197.1 billion Yuan (about 29.5 billion U.S. dollars)¹⁰.

YUAN TRADE SUPPORTING INFRASTRUCTURE

To develop an offshore currency market and supporting Yuan internationalization, the State Council has also begun to allow financial institutions registered in Hong Kong to issue Yuan-denominated bonds¹¹. For the offshore Yuan market, In May 2009, HSBC and Bank of East Asia became the first foreign banks to gain approval to sell Yuan bonds in Hong Kong¹². This issuance will give liquidity support for those Yuan trade settlement. Bank of China (BoC) has already been selling Yuan-denominated bonds in Hong Kong since 2007¹³. In June 2009, China launches a new multilateral net settlement system, which will be run by the China Foreign Exchange Trade System (CFETS)¹⁴. The CFETS is the foreign exchange and money-market trading platform of the People's Bank of China, China's central bank.

CURRENCY SWAP AGREEMENTS

China first used currency swap arrangements to promote both its economic interests and geopolitical agenda in 2001, when it signed the first of four swap agreements with ASEAN nations Indonesia, Malaysia, Thailand, and South Korea under the Chiang Mai Initiative¹⁵. Most recently China has concluded of six currency swap agreements with Argentina, Belarus, Hong Kong, Indonesia, Malaysia, and South Korea, respectively. Since the G-20 summit in November

2008, the People's Bank of China (PBOC) has signed bilateral currency swap arrangements totaling Yuan650 billion (US\$95 billion)¹⁶. China and Brazil announced more direct plans on May 18, 2009 to settle China's imports from Brazil in Yuan, while Brazil's imports from China would be paid for in real, bypassing the use of the U.S. dollar¹⁷. In November 2010, Russia and China decided to use their own currencies rather than US Dollar for trade settlement¹⁸.

DIVERSIFICATION OF RESERVE

China is insistently pursuing diversification into commodities, particularly oil. In early 2009, China made a deal with Russia which involves a \$25-billion loan from the China Development Bank to Russia's Rosneft and Transneft in return for secured oil deliveries for the next 20 years¹⁹. In May 2009, another deal settled with Brazil involving US\$10 billion loan to develop oil reserves and for Petrobras to supply crude to China's oil companies over the next 10 years²⁰. In July 2009, China signed a deal with Ecuador to secure supplies of oil over the next two years²¹. China's National Energy Administration announced that it would build 8 new strategic petroleum reserves bases by 2011, making it to total 12 bases²². China is aiming for 100 days of reserves by 2020²³.

CHINESE GOVERNMENT APPEAL

People's Bank of China released a paper by Zhou Xiaochuan²⁴, the central bank's governor, on March 23, 2009. It calls for replacing the dollar as the dominant world currency and creating "an international reserve currency that is disconnected from individual nations and is able to remain stable in the long run". His paper includes specific steps to reduce China's reliance on the dollar and implicit references to an increased role for China's Yuan (i.e., "the basket of currencies forming the basis for SDR valuation should be expanded to include currencies of all major economies, and gross domestic product may also be included as a weighting"). Another far-fetched proposal made by Zhou in his paper that expanded use of the SDR as a settlement currency in international trade & financial transactions, including commodities pricing.

INFERENCE FROM THESE CHINESE STEPS

With increasing trade settlement in Yuan what is happening is that China is trying to reducing reliance on Dollar. As far as bilateral trade agreements are concerned, these agreements seem to be more oriented at trade finance and political goodwill rather than spreading or augmenting Yuan use as reserve. Yuan is not convertible; a Latin American country like Brazil could not sell Yuan to defend its currency which is a classic use for foreign reserves. They can only use these to pay for imports of Chinese goods, basically a good option while dollar liquidity remains a problem for many countries during the current global financial crisis. Another justification for these currency swaps and trade-financing agreements is that it will help to lock in China's future need of raw materials and commodities. Argentina, Indonesia, Malaysia -all these are source for various commodities. Also Argentina, Indonesia and South Korea were among the countries that were facing short-term liquidity problems in 2008 which turned to China for assistance²⁵. Comparing the trillion dollar reserve of China, these currency swap deals or trade statistics are minimal. Also by basic economics, China can't initiate any major sell-off because the resultant decrease in Dollar value would only reduce the valuation of Chinese reserve assets.

According to IMF press release²⁶ to include a currency in SDR two important criteria is largest export and freely usable currency. At present there is four currency in SDR basket but there is no specific regulation or standard for inclusion of only four currencies - from 1981-98 SDR included five currencies²⁷. So additionally Yuan can be included if it deemed fit. On export front China is global leader but Yuan is not a freely usable currency therefore inclusion in SDR is not probable; at least not now. Zhou admits that "the reestablishment of a new and widely accepted reserve currency with a stable valuation benchmark make take a long time"²⁴.

ANALYSIS OF OTHER FACTORS FOR YUAN AS RESERVE CURRENCY

Going by the economic forecasting from Goldman Sachs²⁸, PWC²⁹, Standard Chartered³⁰ China is likely to surpass US economy sometime in 2027, 2030, and

2020 respectively. Very clearly it is largest positive factor that can lead the Yuan to become Reserve Currency. But is it sustainable thereafter? We know keeping the numero uno spot is tougher than getting there. One crucial element is that China will face the demographic ageing effect which can slow down the growth momentum. Another Goldman Sachs report³¹ suggest that. If the Chinese government changes the one child policy then matter might look different.

Though China has been able to keep low inflation and exchange rate stability so far (various economic statistics shown in Exhibit 1), but it maintains capital controls and a quasi-pegged exchange rate. Sudden opening of market have its risks like undesirable appreciation of Yuan, financial instabilities such as speculative capital inflows, asset bubbles and short-term ostensible shocks to employment and business. China have to opt for plodding currency convertibility roadmap along with the necessary domestic institutional reforms i.e. central bank independence, inflation targeting, changing the state-controlled credit approach, reducing the NPA of banking system³², developing a deep and sophisticated capital market. In Jan 2010 China has just started stock index trading, margin trade, shorting³³. In Nov 2010 China indicated the gradual realization of capital account convertibility; also it is focusing stimulating domestic demand so that economy becomes less export-oriented which will give scope for policy flexibility³⁴. present in Chinese capital market qualified foreign funds are allowed to purchase only up to \$30 billion³⁵ but trillions of dollars can be sunk into secure U.S. Treasuries, which have no limits on foreign purchases. Albeit a long way to go from here, but China is taking steps and in this process it always has to think of rebalancing with the other counterpart US.

Let's assume China makes its Yuan fully convertible today. What could be its share in world's reserve holding? Referring to an econometric analysis in BIS research paper³⁶ "applying China's data, the Yuan's share in the world reserve holdings would be 12.7% according to the linear model and 4.4% based on the nonlinear model. They suggest that the Yuan's potential as a reserve currency would be comparable to the case of the Japanese yen and British pound should the Yuan become fully convertible today".

Last but not least, though China enjoys so-called communist & authoritarian political stability, but it has a poor law & governance image (low ranking in rule of law, control of corruption, economic freedom index as shown in Exhibit 2,3) so network externality factor is in negative side of China. Even talking of transparency, China still do not report official figure of its reserve composition to IMF. As long as it continues to compare poorly with the US and Euro zone, foreigners will remain reluctant to invest in Yuan assets.

OTHER MAJOR CONTENDERS OF RESERVE CURRENCY

Since its inception in 1999, the Euro has advanced to become a key global reserve currency, second only to the dollar, and accounting for more than 25% of total international reserves. Also, while euro area government securities markets are fairly large, they are fragmented because of the heterogeneity in government credit risks. Furthermore, recent debt crisis, fiscal and balance of payments problems in some Euro area countries have weakened the position of euro at the moment. Lately, debate is cooking on possibility of a new world reserve currency, most likely building on SDR. This idea has been endorsed by former World Bank chief economist Joseph Stiglitz³⁷. Even with the new \$250 billion allocation of SDRs just implemented by the IMF³⁸, total volume of SDR in existence is less than 5% of global non-dollar reserves³⁹. It is not enough to make a significant difference and question of supply flexibility and managing authority remains. Without an effective government to back it, a world reserve currency of this kind would have obscurity attaining a minimal level of credibility.

CONCLUSION

Success of Yuan's international ambition depends upon many factors like: realizing full convertibility of the Yuan, to liberalize and strengthen domestic financial system and marketplace, flexibility of the Yuan exchange rate, with necessary adjustment of the legal system. The network externality is currently favoring the dollar and the euro. Apart from economic aspects, geopolitical elements are equally important. It depend on China's serene rise, Japan's response to

China's growing influence in Asia, and the United State's reaction to China's rise in the world. IMF Coffe data shows Dollar is still the leader but its share of currency reserve is slowly diminishing (Exhibit 4). Policymakers have learned from the global economic history that single hegemony is subject to triffin dilemma and vulnerable to shock and volatility during crisis and adjustments. As changing economics, technology and globalization is transforming this world in a multi-polar structure⁴⁰; there are expectations of possible multi-polar reserve currency

system⁴¹ so in future it would be possible for two or maybe three major reserve currencies to co-exist³. Looking at the qualitative and quantitative arguments it is more likely that rather than out rightly replacing Dollar; in next 15-20 years Yuan will emerge as one of the internationalized currency with potential of becoming reserve currency rival along with USD and Euro. The strength of that system will depend on the future economic, financial, political dynamics and development.

LIST OF EXHIBITS

Exhibit 1.

Years----->	Units	2003	2004	2005	2006	2007	2008	2009
Economic indicators								
Nominal GDP	USD bn	1641	1932	2236	2658	3382	4518	5027
GDP growth (real)	% yoy	10	10.1	11.3	12.7	14.2	9.6	9.1
Industrial production	% yoy	16.7	16.2	15.9	15.4	17.4	12.9	12.3
CPI	% yoy aop	1.2	3.9	1.8	1.5	4.8	5.9	-0.7
Exports	USD bn	438.3	593.4	762.5	969.7	1220	1435	1204
Imports, cif	USD bn	393.6	534.4	628.3	751.9	904.6	1074	954.3
Trade balance	USD bn	44.7	59	134.2	217.7	315.4	360.7	249.5
Current account	% GDP	2.8	3.6	7.2	9.4	11	9.4	5.9
FDI (net)	USD bn	50.7	55.1	60.1	55.1	57	52.4	46.1
Intern. reserves (excl. gold)	USD bn eop	408.3	618.6	825.7	1073	1530	1948	2416
Import cover	months eop	10.4	11.8	13.4	14.4	16.8	18.1	24.6
External debt	% GDP	12.8	12.8	12.6	12.2	11.1	8.3	8
External debt (government)	% GDP	0.6	0.5	0.4	0.3	0.2	0.2	0.1
Fiscal balance	% GDP	-2.2	-1.3	-1.2	-0.8	0.6	-0.4	-2.2
General Govt. gross debt	% GDP	19.2	18.5	17.8	16.5	20.2	17	17.5
Financial market indicators								
Exchange rate	USD aop	8.28	8.28	8.19	7.97	7.61	6.95	6.83
Exchange rate	EUR aop	9.45	10.34	10.15	10.09	10.49	10.23	9.53
Real ex. rate (USD), Jan 00=100	aop	92.4	93.5	93.1	94	100.4	112	113.5
REER, Jan 00=100	aop	94.1	91.9	93.7	96.3	101.8	108.6	108.9

source: <http://www.dbresearch.com>, country infobase

Exhibit 2.

Country	Year	Control of Corruption		Rule of Law	
		Percentile Rank (0-100)	Governance Score (-2.5 to +2.5)	Percentile Rank (0-100)	Governance Score (-2.5 to +2.5)
BRAZIL	2009	56.2	-0.07	49.5	-0.18
CHINA	2009	36.2	-0.53	45.3	-0.35
FRANCE	2009	90.5	1.41	89.6	1.43
GERMANY	2009	92.9	1.7	92.9	1.63
INDIA	2009	46.7	-0.33	55.7	0.05
ITALY	2009	59	0.05	62.7	0.39
JAPAN	2009	87.1	1.35	88.2	1.31
RUSSIA	2009	11.4	-1.12	23.6	-0.77
UNITED KINGDOM	2009	91.4	1.54	93.9	1.71
UNITED STATES	2009	85.2	1.18	91.5	1.53

Source: World Bank

Database(<http://info.worldbank.org/governance/wgi/index.asp>)

Exhibit 3

Country	2010 World Ranking	2010 Overall Score	Some Specific Sectional score					
			Business Freedom	Trade Freedom	Investment Freedom	Financial Freedom	Property Rights	Freedom from Corruption
BRAZIL	113	55.6	54.5	69.16	45	50	50	35
CHINA	140	51.0	49.7	72.16	20	30	20	36
FRANCE	64	64.2	86.3	82.48	50	70	80	69
GERMANY	23	71.1	89.6	87.48	85	60	90	79
INDIA	124	53.8	36.3	67.94	35	40	50	34
ITALY	74	62.7	77.9	87.48	75	60	55	48
JAPAN	19	72.9	84.5	82.38	60	50	80	73
RUSSIA	143	50.3	52.2	68.42	25	40	25	21
UNITED KINGDOM	11	76.5	94.9	87.48	90	80	85	77
UNITED STATES	8	78.0	91.3	86.92	75	70	85	73

Source: <http://www.heritage.org/Index/ranking>

Exhibit 4

Currency	1996	1999	2002	2005	2008	2009
Total foreign exchange	1,566,268	1,781,947	2,407,978	4,320,126	7,337,427	8,169,036
Allocated reserves	1,224,464	1,379,705	1,795,994	2,843,625	4,210,072	4,563,579
Claims in U.S. dollars	760,071	979,783	1,204,673	1,902,535	2,698,423	2,837,121
Claims in pounds sterling	32,883	39,827	50,537	102,243	168,793	195,137
Claims in Japanese yen	82,307	87,939	78,145	101,769	131,901	134,177
Claims in Swiss francs	3,705	3,172	7,314	4,143	5,799	5,300
Claims in Euros	...	246,950	427,406	683,893	1,112,317	1,250,258
Claims in other currencies	53,172	22,034	27,919	49,041	92,839	141,586
Unallocated reserves	341,805	402,242	611,984	1,476,501	3,127,355	3,605,458

source: <http://www.imf.org/external/np/sta/cofer/eng/index.htm>

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