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The Internationalisation of the Yuan (I)

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The issue of turning the yuan into an international currency is the subject of much controversy. Some believe that Beijing should opt for full convertibility of the yuan, turning it into a fully-fledged international currency. Others believe that the yuan is already an international currency, citing impressive figures that reflect the growing use of the Chinese currency in international trade. Still others hold the view that turning the yuan into an international currency would be of no benefit to Beijing, and the Chinese authorities are even intentionally preventing it. The complexity of the problem lies in the fact that moving the yuan towards internationalisation involves three distinct phases: turning the Chinese currency into a) a trading currency, b) an investment currency, and c) a reserve currency...

The yuan as a trading currency

The process of turning the yuan into an international trading currency began after the 2007-2009 financial crisis, which exposed the precariousness of the world's leading currencies – the dollar and the euro. China's main trading partner was, and still is, the US, and the only currency used in China's foreign trade with America is the US dollar. However, the dollar does not just predominate in China's trade with the United States, but with other countries as well. The first steps towards the internationalisation of the yuan emerged in 2008-2009. At that time, businesses and companies were allowed to use the yuan in trade with [Hong Kong](#) (Xianggang), Macau

(Aomen), and ASEAN countries. In the middle of 2009, just 365 companies had the right to use the yuan in international trade transactions, but by the end of 2010 this number had grown to 76,359. In 2012, every Chinese company with a licence for export and import transactions was able to use the yuan. An active transition to foreign trade settlements in yuan is happening alongside an increase in the use of the national currencies of China's trading partners. This is being facilitated by the signing of bilateral currency swaps between the People's Bank of China (PBC) and the central banks of China's trading partners. To date, the PBC has signed more than 20 currency swap agreements. While just 3 per cent of China's foreign trade was settled in yuan in 2010, by the end of 2013 this figure had reached 18 per cent. And according to HSBC forecasts, this share is expected to grow to 30 per cent by 2018.

At the end of 2013-beginning of 2014, the yuan overtook the euro in terms of the amount of payments used for international trade, and took second place after the US dollar. It is significant that the yuan is even being used in trade between China and the US, although its share of the bilateral trade between China and the US does not yet exceed 2 per cent.

The position of the yuan in the total number of international currency transactions in the world is much more modest. Besides being used to settle trade in goods and services, the Chinese currency is also used to exchange for other currencies (the foreign exchange market) and for a variety of credit and investment transactions (stock and other financial markets). Ten years ago (in 2004), the yuan was only the 35th most internationally traded currency. At the beginning of 2012, it had risen to 13th place, and at the beginning of 2014, the Chinese currency was already in 7th place, having overtaken, for example, the Swiss franc.

On the convertibility of the yuan

The position of the yuan in the overall number of international currency transactions largely depends on its convertibility. At the moment there is partial convertibility, which means it is possible to freely use the yuan for current transactions, first and foremost trade transactions. Partial convertibility was introduced in 1996, and at that time the Chinese authorities declared another ten years would be needed to move to a fully convertible yuan, so to lift restrictions on capital transactions, in other words. Eighteen years have passed since then, however, and the restrictions are still in place. Obviously, turning the yuan into a freely convertible currency would drastically increase the scale of the yuan's use in global currency turnover, but this would only be a short-term effect, and the risks to the Chinese economy would rise sharply. Until comparatively recently, the yuan was a currency with a fixed exchange rate that was also undervalued, which made it a tool for the active expansion of China's foreign trade. Since the 2000s, Beijing has refused to administer the exchange rate; officially the exchange rate became floating, but adjustable. It is regulated by the People's Bank of China which, by systematically buying up dollars, euro and other currencies, is artificially curbing the growth of the yuan's exchange rate, keeping it at a lower level than the purchasing power parity of the yuan and the dollar. If the yuan becomes fully convertible, then there is a risk that the PBC would lose control of the exchange rate of its own currency, and this would be a direct threat to China's current economic model, which is based on trade expansion. China's economy, even with its undervalued yuan, is already facing certain problems since the global market is saturated with Chinese goods and further export expansion is difficult. The issue of the exchange rate regime of

the yuan will be decided depending on what the future model of China's economy turns out to be, but the country's leadership is not fully in agreement on this matter. Without a clear long-term economic development strategy, however, the transition to a freely convertible yuan will end up being a concession to pressure from the West and will come with serious risks.

Unofficial statements by Chinese leaders that it would be a good idea to make the yuan a freely convertible currency first appeared in 2011, as the country marked the 35th anniversary of the death of Mao Zedong. The Third Plenum of the Central Committee of the Communist Party of China was held in November 2013, at which two camps revealed themselves: a) those in favour of the development of the domestic market and China's transformation into a country with a developed and independent economy; and b) those in favour of China's rapid integration into the global capital markets. Official reports said that the country would move towards a full convertibility of the yuan. This means that the second camp got the advantage, and the supporters of the first camp only managed to ensure that the transition to a freely convertible yuan would be gradual rather than abrupt.

Moving towards investing in yuan: five small steps

Yuan used in foreign trade accumulates in the accounts of foreign companies that supply goods to China. Nowhere near all of the export revenues are used by China's trade partners for the subsequent purchase of goods in China with this same yuan. According to the PBC, there was more than 1.3 trillion yuan overseas at the end of 2013, which is equivalent to approximately US \$250 billion. In fact, this money is forming an offshore yuan market. It is as though two types of yuan have emerged: a) onshore yuan (yuan that is kept and circulated within China); and b) offshore yuan (yuan that is kept and circulated beyond China's borders). Their values are not the same and they have separate exchange rate quotes.

Any further dynamic development of trade in yuan is only possible if a way is found to quickly use the yuan accumulated abroad. It is possible to use the yuan to buy goods in China, of course, but foreign holders of yuan would like to widen their range of possibilities. Namely: a) changing yuan into other currencies as required; and b) buying not just goods in China, but also assets (i.e. investing in the Chinese economy).

One of the steps towards turning the yuan into a freely convertible currency is the signing of an agreement between China and other countries on the conversion of the yuan into other currencies. At present, the yuan can be directly converted with the US dollar, the Japanese yen, the Australian dollar, the Russian rouble, the Malaysian ringgit, and the New Zealand dollar. The latest such agreement was signed between China and New Zealand in March 2014.

A large amount of yuan received by China's trade partners is piling up in bank accounts in Hong Kong, which has been dubbed the offshore yuan market. At the beginning of this year, yuan deposits amounted to nearly 12 per cent of all deposits in Hong Kong's banking system (in 2008 this figure stood at just 1 per cent). Simplified coordination procedures are permitted between this offshore market and China's domestic market, which make the Hong Kong yuan more convertible. Hong Kong is acting as a kind of gateway between China's domestic market and the

global market.

After Hong Kong, London is the second biggest offshore market where the yuan is traded. At the beginning of this year, just four offshore markets that traded the yuan with a wide range of other currencies were in operation: Hong Kong, London, Singapore, and Taiwan. Another location is expected to emerge this year – in Frankfurt. The People's Bank of China and the Bundesbank have agreed to establish a centre for the clearing and settlement of payments in yuan.

Since December 2010, the yuan has also been traded against the Russian rouble on the Moscow Stock Exchange. Exchange trading in the rouble-yuan pair was simultaneously launched on the Shanghai Stock Exchange. Based on the figures for 2013, trading volumes in the yuan-rouble pair were 3.5 times higher in comparison to 2012, amounting to more than US \$100 billion.

Yuan trading on various trading platforms increases the demand for the Chinese currency, but the main question remains: what can the yuan accumulated be invested in? And this once again raises the issue of the yuan's full convertibility. To accomplish this, it is necessary to liberalise the access of foreign investors to China's domestic market on the one hand, and remove restrictions on the export of capital from China on the other. Small steps in these two directions are being made every year and, at the present time, almost every month.

According to IMF recommendations (which are as good as demands), for the country to be able to announce the full convertibility of its currency, it must have well-developed domestic financial markets. In a broad sense, therefore, convertibility involves not just the opportunity to buy and sell currencies at the market (floating) rate, but also the free purchase and sale of bonds and shares (the convertibility of securities). Generally speaking, there is already a capital market in China, and it is third in the world in terms of total capitalisation. As experts say, however, the domestic financial market is still not very flexible, and is under strong administrative pressure from the state. In 2014, Beijing announced the liberalisation of credit interest rates, which, according to Western experts, is a significant step towards the creation of a fully-fledged domestic capital market.

The Shanghai Free Trade Zone, which foreign investors have access to, began operations in September 2013. It is a unique experimental platform where full conversion of the yuan is allowed. At the beginning of 2014, the People's Bank of China issued bonds worth 2.5 billion yuan, and the securities were floated in London. At approximately the same time, the China Securities Regulatory Commission issued a license for direct investment in China to a British management company. It is the first time that such a licence has been obtained outside Hong Kong or mainland China. In January 2014, a Chinese exchange-traded fund (ETF) started trading on the London Stock Exchange. The particularly close relationship between Beijing and London is visible to the naked eye. Anglo-Chinese relations were given another boost on 31 March 2014, when the Bank of England and the People's Bank of China signed an agreement on the establishment of a yuan clearing house in London.