The Economist

Banyan

The red and the green

The Chinese yuan's relentless ascent to international status is a perilous undertaking

Apr 26th 2014 | From the print edition

OUTSIDE China, Mao Zedong is out of fashion these days, remembered less as a revolutionary hero than as a tyrant. But the currency which sports his image on its banknotes is making headway abroad. In Hong Kong some cash machines dispense the "redback", as the yuan or *renminbi* is known. In Mongolia 60% of cash in circulation is estimated to be Chinese. The yuan, whose internationalisation really began only in 2009, is now reckoned the seventh-most-used currency in the world, up from 13th a year ago. When China, the world's biggest trading nation, becomes in the next few years its biggest economy too, many Chinese expect the currency to match its status, ready to challenge the dominance in the global monetary system enjoyed by the American dollar. They will probably be disappointed.

Until 20 years ago, the yuan was so domestic that foreigners in China were supposed to use vouchers called "foreign-exchange certificates" instead. Now landmarks of the yuan's advance appear every week. This month a long-stalled agreement linking the Hong Kong and Shanghai stock exchanges and allowing trading to be settled in yuan got a green light. Singapore, London and Frankfurt are also vying to become yuan-trading hubs. China's central bank has signed swap arrangements with more than 20 countries. The market in yuan-denominated "dim sum" bonds issued offshore (mainly in Hong Kong) is growing.

Some 18% of China's foreign trade is now settled in yuan, a proportion the Hong Kong Monetary Authority expects to reach 30% next year. Some central banks already hold a small chunk of their countries' foreign-exchange reserves in yuan. Economists even talk of an emerging "yuan bloc", encompassing China, Hong Kong, Taiwan and the ten members of the

Association of South-East Asian Nations. The globalisation of the yuan seems remorseless and unstoppable.

Eswar Prasad, an economist and author of a new book on the global monetary system, “The Dollar Trap”, is less sure. He points out that the internationalisation of a currency has three essential aspects. In the first, its use in settling trade and financial deals, the yuan is well advanced. But it has barely started on the second, the liberalisation of China’s capital account so that the yuan can be freely converted with other currencies at market rates. Without that convertibility, much deeper domestic financial markets and a floating exchange-rate, the yuan will not achieve the third essential—becoming a global reserve currency, such as the dollar, euro, yen, sterling or Swiss franc. For now, the yuan’s exchange rate is tightly managed, to the irritation of trading partners, which believe it is kept artificially cheap.

Mr Prasad says that China’s policymakers see the yuan’s possible accession to the status of a fully-fledged reserve currency as at best a “mixed blessing”. But for a number of reasons, influential lobbies in China are pushing the idea. One motive is simple prestige. As Di Dongsheng of Renmin University in Beijing puts it in a chapter in another new book, “The Power of Currencies and Currencies of Power”: “Great powers have great currencies, and a solid currency helps to build up power.” The global financial crisis of 2008-9 revealed to China the fragility of the present system and the extent to which its own finances are beholden to America. Perhaps two-thirds of its nearly $4 trillion-worth of foreign-exchange reserves are in dollars. Chinese economists argue that, over time, America will reduce its debt burden through inflation, weakening the dollar and costing China a fortune.

Moreover, through its investments in US Treasury bonds, China is in effect financing America’s continued military predominance. And reformists see currency liberalisation much as they saw WTO accession in the late 1990s: a way external pressure can force powerful domestic lobbies to reform. They hope it can improve China’s financial system, which lacks both depth and respected regulators. In particular they hope to force banks to compete for savings in a system that at present, by keeping deposit rates low, penalises small savers in favour of big state-owned corporate borrowers, and has inflated a property bubble.

Some economists also see a short-term incentive to remove capital controls. They believe that steady appreciation for nearly a decade, coupled with higher inflation in China than in America, has left the yuan overvalued against the dollar. Loosening controls, they argue, would prompt an outflow of Chinese capital, which in any event is seeking foreign havens. The yuan would weaken, boosting the economy at a time when it has just recorded its lowest quarterly growth rate since 2012.

Fear of freedom

But this argument also helps illustrate just how risky and frightening for a Communist Party planner is the notion of capital-account liberalisation. Economists cannot agree on something as basic as whether the yuan is too cheap, meaning that liberalisation would lead to a surge of capital inflows, or too dear, so that money would flow out of China if the exchange rate were freed. How many other uncertainties would China face if capital controls were lifted? And whatever its short-term path, Chinese economists believe the long-term trend is for the yuan to strengthen. Losing the ability to manage its rise would be to sacrifice what has been an important instrument of policy.

Another reason for caution is the attitude of other countries to the rise of a currency backed by a government that is unaccountable at home and developing a reputation as a bully in its near-abroad. In another chapter in "The Power of Currencies", Yuriko Koike, a former Japanese defence minister, worries about how China might exploit financial power. His fears are shared among ordinary people. In Myanmar, for example, Huawei phones and Kenbo motorcycles are all the rage, but people still grumble about China's expanding presence. For that reason, among others, the banknotes they covet bear a picture of Benjamin Franklin.

Economist.com/blogs/banyan (http://www.economist.com/blogs/banyan)

From the print edition: China