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World sheds reserve over growing role of China's yuan

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China's yuan will one day compete for a place alongside the mighty dollar as a reserve currency hoarded by central banks, analysts say, as US Treasury chief Jacob Lew visits Beijing to push for faster reform.

Communist authorities tightly control the rate of the yuan -- also known as the renminbi (RMB) or "people's money" -- and limit capital flows into and out of the country.

But China -- already the world's second largest economy -- is gradually moving to implement financial reforms, make its exchange rate more flexible and open its capital account for investment and financial transactions, rather than trade-related ones.

The slow pace of change, though, has frustrated Washington and the currency will be on the agenda as Lew discusses "progress on China's reform agenda" with Premier Li Keqiang and other top officials on Tuesday.

"Clearly the renminbi has traction. If you look at any measure of the renminbi's internationalisation... the trajectory looks very sharp," said Eswar Prasad, economics professor at Cornell University and author of "The Dollar Trap", which argues that the ubiquitous greenback is an inescapable necessity for now.

Efforts so far have focused on transforming China's special administrative region of Hong Kong into the world's centre of "offshore" yuan trading, where banks take deposits and financial institutions issue bonds denominated in the currency.

An agreement announced last month will let Chinese investors invest in Hong Kong's stock market using yuan, while a free-trade zone launched in the commercial hub Shanghai last year aims to pilot reforms for full convertibility of the currency.

"If China moves forward with its financial market and economic reforms, the renminbi will become a viable, possibly significant, reserve currency," said Prasad, previously head of the International Monetary Fund's China division.

Despite the fact that the yuan cannot be freely bought and sold, some central banks already hold it in their reserves including Chile, Nigeria, and South Korea, he said -- countries with significant economic relations with China, one of the world's biggest traders.

Even Japan, with which political relations are deeply strained, holds some.

- Safe haven doubts -

Beijing's controls on its value mean that the yuan is one of the world's less volatile currencies, with a fixed value until mid-2005, steady appreciation for the next three years, a two-year pause for the global financial crisis, and then gradual strengthening against the dollar until the beginning of 2014. So far this year, though, it has lost nearly three percent, closing Monday at 6.2369 to \$1, with analysts attributing the fall to deliberate central bank action in a bid to chase speculative funds betting on continued appreciation out of the market.

Exchange rate control is one of the ruling Communist Party's key tools to maintain its economic grip and analysts say the central bank guides the currency in the direction it wants while imposing restrictions on its daily movement, limiting the effect of market forces.

"It's important that China demonstrates a renewed commitment to move to a more market-determined exchange rate which will help provide for more balanced domestic growth and global trade," Lew said Tuesday, urging Beijing to move to "a more transparent exchange rate policy".

The yuan is unlikely to become a true "safe haven" currency as highly regarded as the US dollar, Prasad said, because China lacks the trusted public institutions and independent judiciary of the United States.

"There will be more money coming in for yield, for diversification but with money coming in for safety? I think not," he said.

The People's Bank of China, the central bank, in March widened the yuan's trading band, allowing it to move up or down two percent daily -- double the previous one percent -- on either side of a mid-point set under the bank's supervision.

"The mid-point reflects the guidance and intentions of the government," said Jiang Shu, a foreign exchange analyst with Industrial Bank.

- 'Serious concerns' -

The yuan's fall this year has upset major trading partners who believe the currency is vastly undervalued, with the US Treasury saying last month the decline raised "particularly serious concerns".

Chinese officials defended the currency's movements as normal.

"In the history of international finance, no matter what currency exchange rate regime is adopted, there has never been a currency only rising and never declining," Guan Tao of the State Administration of Foreign Exchange, which advises on policy, said in the Shanghai Securities News.

Analysts still expect the yuan to recover to end flat on the year, while pressures for future appreciation will continue.

"The renminbi is an alluring story," said Prasad of Cornell, "because of course the Chinese economy on its present growth trajectory could match the size of the US economy some time in the next 10 to 15 years.

"Expect the long term money to keep coming here."

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