Internalisation of the Chinese yuan

One corollary of China's growing importance as a global economic and financial power is the purposeful way in which it is encouraging the use of the Chinese currency in the global markets. As seems to be its wont, once a strategic decision is taken, it is pursued relentlessly and rapidly, if only in a step by step fashion.

A few years back, a pilot program was launched permitting trade transactions by companies in five cities to neighbouring countries, to be invoiced in the yuan. In July 2009, the pilot program was extended to all importers and exporters in twenty provinces and to all trading partners. Reports suggest that the authorities are targeting for 50% of China's trade to be invoiced in the domestic currency, over the next five years. Given that the currency has only one way to go, namely up, Chinese exporters have an obvious incentive to quote prices in yuan rather than in the dollar. It may be recalled that many of the power plants for which orders have been placed with Chinese suppliers by Indian companies, have been contracted in the Chinese currency. And, it seems that the importers were encouraged to agree to yuan pricing by offering them a discount over the dollar price. In the context of the restrictions on non-residents entering the domestic foreign exchange market, hedging for such transactions seems to be getting done in the off-shore, non-deliverable forward market. In order to facilitate invoicing and settlements in yuan, the Chinese central bank has also entered into bilateral swap facilities with east Asian central banks.

Overall, it seems that China is closely following the Japanese model in the internationalization of its currency. In the 1950s, most of India's trade with Japan, both imports and exports, was denominated in the US dollar. In the 1960s, Japanese exporters, particularly of capital goods, started shifting to yen invoicing of their exports to India. By then, Japan had started accumulating current account surpluses, with every prospect of currency appreciation – exactly what the situation in China today is.

One major advantage China has in internationalizing the yuan is the existence of a leading global financial centre, namely Hong Kong, next door. Hong Kong has its own currency although it is technically a Special Administrative Region (SAR) of China. This allows the Chinese authorities great flexibility in creating an off-shore market in the yuan, even while keeping tight control on the exchange rate in the domestic market. The issue of yuan denominated bonds in Hong Kong was first permitted in June 2007, but with the issues restricted to financial institutions. The Asian Development Bank and the International Finance Corporation have made yuan denominated bond issues both in the domestic and Hong Kong markets. Recently the Chinese government itself made a yuan bond issue in the SAR. The market has also been extended to commercial, non-financial entities. The issue in Hong Kong of yuan denominated insurance policies and mutual funds has been encouraged. The first yuan denominated equity issue of a Chinese company was recently floated in Hong Kong. There is a rapidly growing market in yuan denominated deposits with the Hong Kong banks – the latest estimate of such deposits is almost CNY 300 bn. Hong Kong apart, the yuan has been freely circulating in some neighbouring countries like Mongolia, Korea, Vietnam, Laos, and Myanmar. More recently, an agreement has been reached with Taiwan to make available yuan currency notes to Taiwanese residents and travelers to the mainland.

Along with an off-shore capital market, Hong Kong also has a rapidly growing foreign exchange market in the yuan. Recently, the settlement of net currency positions in the Hong Kong market in the Chinese domestic market has been liberalized considerably. Overall, the strategic direction and goal are very clear. Reports suggest that most Hong Kong residents would prefer the domestic currency to be de-linked from the U.S. dollar and pegged to the yuan. For some time, the Chinese authorities have been making noises to the effect that it is high time for the role of the U.S. dollar as the principal reserve currency is taken over by a basket of currencies, like the SDR. They are likely to find a sympathetic ear in the French President who has recently taken over as the head of the Group of Twenty for the current year. (The French have long believed that its status as principal reserve currency gives the dollar an exorbitant privilege and huge seinorage gains.) But this apart, it is high time that the yuan becomes a part of the SDR basket.

Tailpiece: As for the Indian rupee, is it not time that we allow it to be used in the duty-free shops at airports? – after all, the currency is convertible for all current account transactions. Again, press reports suggest that, when Iran recently offered to accept payment for oil in rupees, we were not agreeable. Surely, this is a better, if only temporary, solution rather than a stalemate. But, this apart, the latest BIS data, also quoted in the RBI's Financial Stability Report, evidence the huge trading volumes in the INR, in the NDF market abroad.

A. V. Rajwade
Email avrajwade@gmail.com