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Chinese Yuan, Spreading its Wings

China has not only been consistent in pursuing a continuous effort in internationalising yuan, but it has also stepped up its efforts for greater yuan convertibility. China's policy in loosening capital controls has been broad involving different aspects of bringing in capital convertibility as well as making its currency a global one. However, these policies on capital and currency reforms are considered limited for yuan to attain a reserve currency status in the future. For example, Eswar Prasad, the former head of the International Monetary Fund's (IMF) China division, believes that China is taking steps in the right direction; however, a lot needs to be done to improve the domestic financial system in terms of better banking system, broader financial markets and a more flexible currency.

Nevertheless, the efforts of China as well as the achievements thereof have been substantial. China follows a two-pronged approach to build a strong foundation to the path of full convertibility of yuan and is probably aiming at making yuan a reserve currency: first, allowing foreign investors to route their investments in yuan through Hong Kong and, in a limited way, directly into the mainland; and second, increasing trade transactions in yuan.

Capital Convertibility

China has been consistently bringing in reforms to loosen its capital controls. The introduction of the yuan based bonds, the "Dim Sum" bonds, in 2007 was one of the important steps taken by China to allow Chinese companies to raise funds in yuan. These bonds were earlier issued only in Hong Kong. Singapore is another major financial centre where yuan based bond trading occurs; however, it is not the issuer of the bond. Singapore is increasingly competing against Hong Kong, Tokyo, London, and others, to capture the growing offshore activities in yuan, especially after China has been encouraging yuan's cross-border flow. The issuers of yuan based securities can list, quote, trade, clear and settle securities denominated in yuan in the Singapore Exchange Ltd. (SGX). The issuers of yuan securities have the option to offer dual currency trading, either in yuan or Singapore dollar. It is claimed to be the first exchange to offer clearing of over-the-counter foreign exchange forwards for yuan.

However, now London has become the first European off-shore hub for issuing yuan-denominated bonds. There is a long way to go in establishing a strong dim sum bond market in London.[1] The initial size of the bond issued by HSBC in London was $317 million (2 billion yuan) which is relatively smaller than the $16.8 (100 billion yuan) billion worth dim sum bonds issued in Hong Kong in 2011. However, it is considered a milestone in London's efforts to become an offshore yuan-trading centre along with Hong Kong.

Britain and Hong Kong set up a forum in early 2012 to work more closely in the areas of yuan trade clearing and settlement. In order to make it easier to settle yuan transactions in London, Hong Kong is also extending the operating hours of its yuan payments systems.

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The bonds issued for three years are mainly targeted at European investors and will fetch annual interest of 3 per cent.

Experts feel that growth of the dim sum bond market in the UK will be slow as compared to that in Hong Kong because of the liquidity position of London based banks in terms of yuan-denominated deposits.[2] According to the City of London Corporation, there was only 109 billion yuan ($17 billion) of yuan-denominated deposits in London at the end of 2011, against Hong Kong's 566 billion yuan ($89 billion). Even deposits in Hong Kong are considered as modest as compared to the size of Chinese economy. This is because of the capital controls that China maintains on the movement of yuan with the rest of the world.

On the overseas investment front, China has given foreign hedge funds permission to tap the rich citizens to invest their funds overseas. The reform, called the Qualified Domestic Limited Partner programme, allows hedge funds to apply for licenses to register in Shanghai. However, a low ceiling around $5 billion will be placed on the amount that can be raised collectively by the institutions being granted the licenses.

China has been making efforts to make its currency more flexible. The launch of dim sum bonds by HSBC in London followed another major announcement by People's Bank of China (PBoC) that the yuan-trading band would be broadened further increasing from 0.5 per cent to 1 per cent. This means that the yuan can fluctuate according to the market forces by 1 per cent above or below a daily reference exchange rate. China's trade has become more balanced in the recent months as compared to before when cheap labour and undervalued yuan enabled Chinese goods to flood the global market. As a result of the appreciating yuan and a slowdown world over, trade surplus has not been excessive. Hence, the widening of trading band of yuan may be an indication that yuan may have reached its fair value in the market, and the officials are confident to liberalise the trading band further.

Another Experimental Step towards Capital Convertibility

China has further initiated a plan to experiment full convertibility of yuan in Qianhai a small part of Shenzen, the original Special Economic Zone (SEZ) of China. Full capital convertibility and freer yuan usage would be allowed in Qianhai to allow investments and develop it into a financial market as a rival to New York or London. Geographically, it is located at stone's throw distance from Hong Kong and situated in the district of Shenzhen, which is a successful modern city developed after the policy of "reforming an opening" was introduced in 1979 under the economic reforms.

According to the Vice President of PBoC, "The experiment of yuan convertibility under the capital account in Qianhai will mainly be focused on the areas where the convertibility level is low, for example lending".[3] China plans to bring in service sector reforms in a business zone that would offer freer currency movements and the professional standards of Hong Kong would be brought in.

There are 21 firms registered and 170 projects ready to start work in Qianhai and the government aims for 150 billion yuan worth of GDP by 2020 there. The government will also ease the entry rules for companies, offer 15 per cent corporate income tax to some firms and no income taxes on finance professionals, lawyers, accountants, etc, that it hopes to attract.

Investment and borrowing curbs on companies wanting to invest in Qianhai will be removed. Under the plan, basic infrastructure would be put in place by 2015 and by 2020 it will become a global financial services hub. Firms can raise funds offshore in yuan to invest, which is not yet allowed for companies in mainland China. Hong Kong banks will also be allowed to enter the zone easily. However, an easing of capital controls in between Qianhai and Hong Kong would require a tightening of controls between Qianhai and the rest of the mainland. Otherwise, there would be no bar on lending offshore yuan to the rest of the country and yuan inflows would surge.[4]

1 Robin Wigglesworth, "London calling for Dim Sum Bonds". *Financial Times*, 20 June 2012.

2 *Ibid*.

3 "UPDATE 1- China says yuan convertibility in Qianhai to focus on certain areas". *Reuters*, 30 June 2012.

4 Refer to "The More Special Economic Zone". *The Economist*, 7 July 2012

China's continuous experimental policies and currency reforms on freeing the capital account may take time to get to the final target of achieving full convertibility of yuan by 2015; however, the diverse ways in which China is approaching the goal is commendable. The other path of internationalising yuan that China has taken and achieved considerable success in also needs to be mentioned.

Trade Transactions in Yuan

The major development that has taken place recently on China's efforts to increase the circulation of yuan is the direct trading between Japanese Yen and Chinese Yuan started from 1 June 2012. China is the world's second-largest economy while Japan is the third largest, and this step seems to be an attempt to diminish the role of US dollar. This would lower the transaction costs of exchanging currencies and the risk of exchange rate fluctuations between the two big economies in terms of investments as well as trade and also for Chinese citizens studying in or traveling to Japan. It is estimated that about $ 3 billion will be saved each year after this direct currency trading arrangement.

This would also increase the transparency, authenticity and autonomy of the yuan, thus pushing yuan reforms further and enabling an evolution from the managed floating exchange rate regime to a more market determined exchange rate regime.

On the Asian region side, China has also been active in promoting a financial architecture in Asia. Ambassador Shyam Saran in his recent article[5] has commented that China's active role in this direction would establish its economic pre-eminence. There are a series of steps that China has taken in taking the Chiang Mai Initiative of Multilateralisation (CMIM) forward. The CMIM evolved from what was adopted initially by ASEAN as a swap agreement in which five countries, viz. Indonesia, Malaysia, the Philippines, Singapore and Thailand, agreed to provide liquidity support to each other through a $ 200 million fund during the Asian economic crisis of 1997. China did not play a major role then; however, "...it made its relevance felt by pledging not to devalue its currency, which would have hit the competitiveness of the already weakened ASEAN economies."[6] This initiative then got extended to include all ASEAN countries, China, Japan and Republic of Korea.

Bilateral swap arrangements (BSA) for the participating countries were also introduced to allow countries to swap US dollars with their domestic currencies. For 10 per cent of the agreed amount could be utilised without any linkage to an IMF programme for 180 days. For the rest of the amount, the member country had to be under an IMF programme. By April 2009, the bilateral swap arrangements had increased to $90 billion. In May 2011, the ASEAN+3 Macroeconomic Research Office (AMRO) was established as an independent surveillance unit. The ASEAN Members and the +3 countries contributed to the AMRO fund of $120 billion in the ratio 20:80. Japan and China (including Hong Kong SAR) are the major contributors, each having contributed 32 per cent ($38.4 billion) to the fund, while Korea's contribution is 16 per cent ($19 billion).

In April 2012, it was agreed to double the amount of swap available under CMIM from $120 billion to $240 billion, with the current share of financial contributions and voting power among the member countries remaining the same.[7] It is also agreed to set up an ASEAN Infrastructure Fund to channel long-term investments to ASEAN projects which include the ambitious ASEAN Connectivity Initiative. This will create tremendous opportunities for China to play a significant role in the region. China already has currency swap agreements with four ASEAN countries, Republic of Korea and now a direct currency trading arrangement with Japan. All this indicates that China has been proactive in establishing its strong role in the Asian region in the recent years.

A number of countries are now holding the Chinese yuan as a part of their international reserves, such as Malaysia, Republic of Korea, the Philippines, Mongolia, Russia and Belarus. Recently, Nigeria became the first African

[5] Shyam Saran, "The Asian Future of Reserves". *Business Standard*, 16 May 2012.

[6] Shyam Saran, "China and Asian Monetary Fund". *Business Standard*, 20 July 2011

[7] The Joint Statement of the 15th ASEAN+3 Finance Ministers and Central Bank Governors' Meeting [Weblink: http://www.aseansec.org/Joint%20Media%20Statement%20of%20the%2015th%20ASEAN+3%20Finance%20Ministers%20and%20Central%20Bank%20Governors'%20Meeting.pdf]

country to convert its foreign exchange reserves worth $ 500 million in Chinese yuan. The Central Bank of Nigeria will gradually increase its yuan holdings to 10 per cent of its $35 billion in reserves. Beijing recently invested in Nigeria-based rice processing plants and airport development projects in Nigeria. Hence, enhancing greater yuan reserves would prove beneficial for the bilateral relationship.

Recently, more than 20 Chinese and African enterprises have signed eight economic cooperation projects with a total investment of US $ 341 million. In the recent Forum on China-Africa Cooperation in Beijing, China promised to extend $20 million in new loans to African countries for infrastructure and manufacturing. China has been keen in developing strong relationship with African countries in order to be able to tap the vast natural resources for its growth, while catering to the African markets in return.

China has spread its outreach to various regions of the world through its consistent policy initiatives to liberalise yuan and loosen capital controls. Through these steps, it is sending out signals to indicate that China is here to stay despite a slowing economic growth. However, there is a lot that needs to be done to strengthen the domestic economic front without which balanced and stable growth would not be achieved, which is a necessary if China wants yuan to be a reserve currency in the future.

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