RIS Policy Brief
No. 55 April 2012

Internationalisation of Yuan

Introduction

The efforts of China to build a strong position in the global economy have not been deterred by the sliding trends in the developed world. This policy brief tracks the policies being followed by China on internationalising its currency and reducing the need to depend US dollar. It is still in a speculative stage whether the Chinese yuan would dominate the US dollar in the international financial market, or whether it will ultimately mature to attain reserve currency status, given that the amount of trade transactions in yuan has risen dramatically and China has been easing capital controls gradually. If yuan attains a reserve currency status, it would increase the ability of China to borrow its own currency cheaply whenever required.[1]

However, internationalisation of its currency will not confer yuan a reserve status (Prasad and Ye 2012). The set of factors that determine the reserve status of any currency pertain to issuing of country's internal and external policies. Factors like economic size, open capital account, flexible exchange rate, developed financial market and sound macroeconomic policies play an important role in determining whether a currency may achieve reserve currency status. According to the study, the major challenges that China faces in meeting these criteria to make yuan an international currency are:

a) Capital account opening along with other policies, such as exchange rate flexibility and financial market development, and improving the cost/benefit trade-off; and

b) Financial market development, that is, strengthening the banking system; developing deep and liquid government and corporate bond markets, as well as foreign exchange spot and derivative markets.

However, China has been taking strong policy initiatives, to internationalise yuan. These initiatives, that China has taken since 2007 with introducing off-shore bonds, called "Dim Sum Bonds" issued from Hong Kong, indicate towards easing capital controls. Simultaneously, as a step to internationalise its currency, China has been allowing the use of yuan in settling trade transactions by entering into currency swaps agreement with many of its trade partners. To this end, China has been following 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. The following sections discuss the developments taking place in the recent past and the direction to which these developments may be headed.

Slow but Steady Towards Capital Convertibility

China has been easing capital controls to allow foreign investors to invest their money in companies and projects in China. One of the first steps in this direction was allowing foreign investors to purchase bonds denominated in yuan issued from Hong Kong. These are the well known "Dim Sum Bonds" which are issued by China- or Hong Kong-based companies to be bought by foreign investors. Although the Dim Sum Bond market came into being in 2007, the growth of this market has picked up pace in the recent past. Since 2010, China has

RIS Policy Briefs are prepared to communicate results of RIS research on specific policy issues to the policy makers.

This *Policy Brief* has been prepared by Ms. Ramaa Arun Kumar, Consultant, RIS.

laid down policies allowing greater flexibility in operating the market. Till 2010, only Chinese and Hong Kong banks were allowed to issue bonds denominated in yuan; however, now all banks can issue such bonds. On the supply side, the Hong Kong Monetary Authority gave companies greater freedom to sell yuan denominated bonds. As a result, the sale of dim-sum bonds has risen from the third quarter of 2010 onward.

The growing pool of yuan deposits has helped feed demand for Dim Sum Bonds. This has been made possible after Chinese companies were allowed to settle trade transactions in yuan in 2009 through banks in Hong Kong that led to a surge in yuan deposits in Hong Kong banks. Consequently, by December 2011, yuan deposits in Hong Kong were reported to be 588.5 billion yuan (Hong Kong Monetary Authority), around 87 per cent year-over-year increase. Returns on yuan deposits carry 0.6 per cent interest rate, whereas the yuan denominated bonds in Hong Kong yield around 3.8 per cent returns. And with the Chinese government allowing yuan to appreciate slowly against US dollar, there is a speculation of higher future returns in investing yuan denominated bonds. According to HSBC, the total issuance of Dim Sum Bonds in 2012 is expected to reach 260 to 310 billion yuan, doubling from 2011 levels.

In addition, there is fierce competition among major international banks in the offshore trading market for yuan in Hong Kong. Data from Bloomberg survey[2] shows that Bank of China Ltd, which used to manage most of the Dim Sum Bond sales, slumped to 15th place in 2011, while Industrial and Commercial Bank of China Ltd slid to 20th from fourth position. The top banks that arrange for the sale of these bonds in Hong Kong are HSBC Holdings PLC, Royal Bank of Scotland Group PLC and JPMorgan Chase & Co. Banks have been strategising their moves to tap as many Chinese and foreign companies as possible to issue Dim Sum Bonds arranged by them in Hong Kong.

Recently, China Development Bank, which is a lender to the country's local government, sold the longest maturity yuan-denominated bonds in Hong Kong. According to Bloomberg data, the bank offered the 1.5 billion yuan ($238 million) of 15-year Dim Sum securities to yield 4.2 per cent.

There is an increasing list of companies that have been issuing these bonds. China's second largest steel company, Baosteel Group Corporation, also raised 3.6 billion yuan ($565 million) of Dim Sum notes due in three and five years in November 2011. Baosteel became the first Chinese non-financial company to sell yuan bonds in Hong Kong. It is seen as an important deal owing not only to the huge amount raised, but also because of the easing of the restrictions for Chinese mainland companies to sell securities directly. Other Chinese companies that have raised capital through Dim Sum Bonds include BYD Co., Road King Infrastructure Ltd., Guangzhou R&F Properties Co., Zhongsheng Group Holdings Ltd. and China Shanshui Cement Group Ltd.

The growing confidence in the Dim Sum Bond market is evident from the fact that a number of overseas companies have also started issuing these bonds denominated in yuan. McDonald's became the first non-financial overseas company to issue 200 million yuan of debt in August 2010.

UK oil giant, BP Plc issued 700 million yuan bonds maturing in September 2014, while Germany's BSH Bosch & Siemens Hausgerate GmbH, the consumer-brand joint venture, issued bonds of 2 billion yuan ($313.3 million) on the offshore yuan bond market in Hong Kong in September 2011. U.K. retailer Tesco PLC also raised 725 million yuan with its first dim-sum issue. The yuan-denominated bond market has also attracted European companies such as Volkswagen AG and Unilever PLC, as well as US-based companies like Caterpillar Inc.

According to the *China Daily*, in February 2012, the German specialty chemicals company Lanxess AG announced that it will issue Chinese offshore yuan-dominated bonds in Hong Kong worth 500 million yuan ($79.4 million) to build a new leather chemicals plant in Changzhou, Jiangsu province and a new pigment plant.

However, the growing uncertainties lurking in China owing to the pressure built up on

[1] For a detailed insight on the benefits and costs to the country issuing reserve currency refer to "Eclipse: Living in the Shadow of China's Economic Dominance" edited by Arvind Subramanian, 2011.

[2] As reported in China Daily http://www.chinadaily.com.cn/business/2011-05/11/content_12487988.htm

property prices need to be taken as a caution by the investors putting their capital through the Hong Kong route. For example, according to the *Businessweek*, the yuan-denominated three-year bonds sold by Guangzhou R&F Properties Co. have lost 26 per cent since they first issued bonds in May 2011.

Other important aspect that poses doubt on the sustainability of the Dim Sum Bond market is the fact that the banks enabling bond issue are mostly Chinese banks which are questionable given the surge in loan growth during 2009 as part of the stimulus.

However, China has not restricted its policies of internationalising yuan to the offshore bond market alone. A pilot programme has been launched to allow investors to invest directly into stocks and bonds on the mainland. Before this, keeping yuan in banks and investing in yuan-denominated bonds in Hong Kong were the only options available to overseas investors. This move would reinforce the confidence of investors on yuan and make it more attractive if the programme succeeds.

Meanwhile, the United Kingdom has shown interest in playing a key role in China's offshore yuan trading. UK Chancellor of the Exchequer, George Osborne announced during his visit to China in January 2012 the plans to make London an offshore trading centre for China's currency. The UK signed a deal with Hong Kong to this effect to turn London into an offshore trading centre for yuan. Presently, Hong Kong is the biggest offshore trading centre for yuan. This would not only boost China's efforts to internationalise yuan, but also benefit Britain in strengthening its prestige as a global financial centre, besides enhancing its financial business and providing more jobs.

Rising Trade Transactions in Yuan

In addition to allowing foreign investors to easily invest in yuan based financial assets, China has simultaneously been promoting the use of yuan in settling trade transactions with its trade partners, implying lesser dependence on US dollars, which consequently would lead to a reduction of currency conversion costs and exchange rate risks. The progress achieved by China on this front has also been tremendous.

The first step in this direction was taken in July 2009 with a pilot programme whereby a few exporters in five Chinese provinces were allowed to settle trade in yuan. Overseas, the settlement was enabled only for the 10 ASEAN countries, Hong Kong and Macau. However, now all trading partners can engage in settling their bilateral trade with China in yuan.

In addition, China has been signing bilateral currency swap agreements with different countries that allow the two countries to settle trade in their respective local currencies without depending on dollars and also make yuan denominated investments. Since the outbreak of the financial crisis in the US, China has signed such bilateral agreements with 18 countries amounting to 1.93 trillion yuan. The countries with which it has such agreements are listed in the given table 1 below:

Table 1: Currency Swap Agreements of China with Other Countries

Date of Agreement	Central Bank	Value of Swap (in billion Yuan)
December 12, 2008	Republic of Korea	180.0
January 20, 2009	Hong Kong	200.0
February 8, 2009	Malaysia	80.0
March 11, 2009	Belarus	20.0
March 23, 2009	Indonesia	100.0
April 2, 2009	Argentina	70.0
June 9, 2010	Iceland	3.5
July 23, 2010	Singapore	150.0
April 18, 2011	New Zealand	25.0
April 19, 2011	Uzbekistan	0.7
May 6, 2011	Mongolia	5.0
June 13, 2011	Kazakhstan	7.0
October 26, 2011	Republic of Korea (renewal)	180.0
November 22, 2011	Hong Kong (renewal)	400.0
December 22, 2011	Thailand	70.0
December 23, 2011	Pakistan	10.0
January 17, 2012	UAE	35.0
February 8, 2012	Malaysia	180.0
February 21, 2012	Turkey	10.0
March 20, 2012	Mongolia (additional amount)	5.0
March 22, 2012	Australia	200.0
TOTAL		**1931.2 billion**

Source: People's Bank of China.

Among these, the currency swap agreement with Australia is the most recent one signed on 22 March 2012. The purpose of the agreement, according the People's Bank of China, is to help strengthen financial cooperation between the two sides, boost bilateral trade and investment, and promote regional financial stability.

Cross border trade settlement in yuan reached 2.58 trillion yuan (US $408 billion) at the end of 2011 since yuan based trade settlement was first introduced in 2009. The volume of transactions in yuan has increased manifold year after year.

Conclusion

The rise in the number of currency swap agreements does not eliminate the fact that the flow of capital in China is still controlled. Dependence on such measures will not ensure internationalisation of yuan as capital flow in China is still restricted and yuan can flow out of the country through very limited channels. Therefore, the steps taken by China to internationalise yuan are noteworthy; however, China needs to take bolder steps towards an open capital account and flexible exchange rate.

Also, the growth of yuan cross-border trade transactions had been boosted by the growing trade in China. However, in the recent months China's trade growth has slowed down with the first two months of 2012 registering a trade deficit. Also, the investors' weakning confidence in the slowly appreciating yuan paying off on their investments in offshore yuan has created a lack of demand for the yuan. The dollar has been trading in a narrow 6.2900 yuan to 6.3030 yuan range against the yuan offshore since mid-January, very close to its onshore movements. As a result, the total remittance of yuan for cross-border trade settlement amounted to 156.4 billion yuan in January 2012, compared with 239.0 billion yuan in December 2011.

With the economy of China slowing down and the domestic and external problems mounting up, there is a greater need for China to loosen capital controls further to build up greater confidence of its investors, especially when speculations are strong for potential hard-landing of the Chinese economy in 2012. However, with the rising trade deficit in China, it seems unlikely that the government will take drastic steps for making yuan completely market determined and easing other capital controls. This is a dilemma from which the Chinese policy makers need to come out in the near future to maintain a stable growth.

References

Prasad, Eswar and Lei (Sandy) Ye. 2012. "The Renminbi's Role in the Global Monetary System". Global Economy and Development, Brookings Institution.

Subramanian, Arvind. 2011. "Eclipse: Living in the Shadow of China's Economic Dominance". Peterson Institute of International Economics, Washington DC.

RIS Policy Briefs

RIS
Research and Information System for Developing Countries

Core IV-B, Fourth Floor
India Habitat Centre
Lodhi Road, New Delhi-110 003, India.
Ph. 91-11-24682177-80
Fax: 91-11-24682173-74-75
Email: publication@ris.org.in
Websites: http://www.ris.org.in