The Australian

China slowly brings the world to the yuan

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A bank teller counting Chinese 100 yuan notes in Beijing. Picture by AFP
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THE wall is starting to crack.

For years, China has made it tough for capital to flow to and from its economy, the second-largest in the world. Now, the government in Beijing is forging ahead with a campaign to bring the yuan to the world stage - and breaches are appearing in that formidable financial barrier.

A yuan that's more widely used in international trade and investment could eventually challenge the US dollar's supremacy, correct some of the imbalances that plague the Chinese and global economy, and force a profligate US to live within its means.

It won't be an easy transition. There are powerful vested interests in China that are satisfied with the status quo and who will try to put the brakes on any reform effort. But the changes China has made so far have generated momentum both at home and internationally - and may prove too strong to resist.

For more than a decade, China's closed capital account has been a defining feature of the global economy. It has insulated the mainland from international capital flows, enabling China to ride out the Asian financial crisis in 1997 and leaving its banks unscathed by the near-collapse of the US financial system in 2008.

Just as important, denying foreign exchange markets a role in setting the exchange rate has allowed the government to maintain the value of the yuan at an artificially low level - supporting a 30-year export boom. Since Chinese savers can't take their money overseas, banks have also gotten away with offering them low interest rates, keeping the cost of capital for industry at bargain-basement prices and underpinning an investment binge.

Take the example of Shenzhen, a fishing village in 1979, and in 2011 a metropolis of 14 million built around the world's fourth-busiest port. Low-cost capital subsidised the construction of transport and power infrastructure, factories and production lines. An undervalued yuan, combined with low cost of labour, enabled companies to undercut their foreign rivals on price.

But manipulation of the exchange rate and repression of the interest rate comes at a cost. Cheap capital has resulted in overcapacity in the industrial sector and bubbles in the mainland's property market. Managing the exchange rate in the face of trade surpluses has resulted in the build-up of gargantuan foreign exchange reserves - $US3.04 trillion ($2.86 trillion) that China has little choice but to recycle as cut-price loans to the US.

One of the first cracks in China's restrictive policy came in July 2009, with a plan to allow settlement of import and export transactions in yuan. Wider international use of the yuan is intended to reduce transaction costs for China's importers and exporters, guard against the risk of a collapse in US dollar trade financing - as occurred at the end of 2008 - and fly the flag for a rising economic world power.

By the first quarter of 2011, $US55 billion of China's trade - 7 per cent of the total - was settled in yuan. At the end of April 2011, yuan deposits in the Hong Kong banking system had risen to 511bn yuan ($74.21bn), up roughly ninefold from July 2009 when the settlement program was launched.

Restrictions on outbound flows are also being lifted. In the past month, the Shanghai government announced plans to allow residents of the city to make investments overseas.

But more substantial opening of the capital account will require progress in two areas: an exchange rate that is close to fair value and market-set interest rates. The yuan is still undervalued, but two factors suggest it's much closer to market value than it used to be: It has appreciated 20 per cent in real terms against a trade-weighted basket of currencies since 2005, and China's current account surplus fell to 5.2 per cent of gross domestic product in 2010 from 10.1 per cent in 2007.

If the yuan is approaching fair value, the Chinese government will be able to loosen controls on the capital account with less chance of triggering destabilising speculative inflows.

China's interest rates, meanwhile, are still set by the government. But the People's Bank of China is attempting to make progress, by taking a leaf out of the mainland's economic history.

At the beginning of the reform era, China's government designated Shenzhen as a special economic zone where market-based policies could be tried before being expanded to the rest of the country. Hong Kong will serve as a similar site of experimentation for reform of the mainland's financial system. Yields on yuan-denominated debt trading in Hong Kong are already set by the market, rather than with reference to the People's Bank of China's benchmark interest rate.

According to the Royal Bank of Scotland, the value of bonds outstanding in this so-called dim-sum market has risen to the equivalent of $US15.8bn from about $US5.3bn at the end of 2009. McDonald's and Caterpillar are among the companies that have turned to the new market for financing.

The increase in trade settlement and the development of Hong Kong as a yuan financial centre are mutually reinforcing. More yuan trade settlements will add to the pool of liquidity in Hong Kong, encouraging the development of more yuan investment products, and greater variety of investment products reinforces the incentive to use the yuan in trade settlement.

Now pressure is building on China to open further channels into its capital markets. The question is whether change comes fast or slow. China's leaders seemed to be taking the cautious route. The target of making Shanghai an international financial centre by 2020 was regarded as the de facto target date for capital-account opening. But the rapid progress of the past year has raised expectations of opening earlier.

If China accelerates its timetable, the implications are enormous. A higher interest rate will mean slower expansion of investment, eating into the mainland's appetite for commodities and shifting the main domestic growth engine down a gear.

A more expensive yuan will limit demand for exports that have catalysed the explosive growth of China's east coast. Makers of textiles, toys and tools - for whom value-adding levels are low and margins are razor thin - will be the first to shut up shop. High-technology manufacturers like Foxconn - the trade name of Hon Hai Precision Industry, which makes the iPad - have already decided to move production facilities inland, to find cheaper labour away from the coast.

The same dynamic that will make investment less affordable and exporting less profitable means more spending power for China's households - kick-starting efforts to bring domestic demand to the fore as a driver of growth. In the US, businesses from Napa Valley wine makers to manufacturers of cinema projectors in Nebraska are hoping to cash in on the rise of the Chinese consumer.

Not all of the changes will be so positive for the US. Reduced intervention by China in foreign exchange markets will lead to a reduction in demand for US Treasury debt, not just from China but also from other Asian nations that have followed China's lead in managing their exchange rates. That will increase the cost of borrowing for the US, making it more difficult to finance public debt and continued current account deficits.

Giving the yuan a role as a reserve currency held by central banks is the next step in its development, and will require more substantial progress. A capital account that still remains tightly controlled means the Chinese currency can't fulfil the main function of reserves: a liquid asset that central banks can use to stabilise the value of their domestic currency.

The transition to an open capital account won't be easy. Powerful groups in the export sector, state-owned enterprises, banks and local government benefit from a low interest rate and undervalued yuan. The door to reform is not wide open, but neither is it locked.

Reform has its own logic and its own momentum. Companies that raise yuan financing offshore today will demand increased opportunities to bring those yuan to the mainland tomorrow. If interest rates are higher offshore, investors on the mainland will find opportunities to move their yuan in the other direction. If legitimate channels don't exist, companies with an onshore and offshore presence will find ways of circumventing China's capital controls.

We aren't there yet. Yuan deposits in Hong Kong aren't yet equal to 1 per cent of those on the mainland. But the pool of offshore yuan, available at interest rates set by the market, is growing fast, reducing the effectiveness of China's capital controls and the ability of the central bank to use administrative tools to control the mainland economy.

When the tide of offshore yuan starts to wash over the wall Beijing has built around its domestic financial system, the impact on the Chinese and the world economy will be far reaching. China's closed capital account has been the defining feature of the world economy in the past decade; its opening could be the defining feature of the decade ahead.

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