



The yuan goes global

A Mao in every pocket

HONG KONG

China grapples with a huge potential export: its currency

CHINA likes to cover large distances in small steps. Last month it said that a few lucky foreign banks, including central banks, could invest some of the yuan they hold offshore in local Chinese bonds. The first to take up the offer was Malaysia's central bank, the *Financial Times* reported this week. With that purchase, another stone was removed in the great wall shielding China's currency from the outside world.

Global currencies emerge sporadically—the dollar in the first half of the 20th century, the euro over the past decade. That China could even have a plausible claim to such a thing is a remarkable turnaround. Its monetary policy and its mints were often in such wretched shape before the 1949 revolution that old Mexican silver dollars still circulated. The very word “yuan” is a contraction of “yang yuan”, or “foreign round coin”. After the revolution the currency situation got even worse, with ration coupons playing a role in transactions. International deals went through the creaking hands of the Bank of China or, quietly, black markets. It was only in 1994 that a unified, official exchange rate was established.

After solidifying the role of its currency in its domestic market China resisted the next logical step. It kept a tight grip on the flow of capital across its borders. And even as its companies conquered world mar-

kets, they priced their goods in other people's money. The limits on conversion allow China's authorities to steer the economy and control business. But this strategy has exposed China's companies to potential foreign-exchange risk, one reason why the authorities are reluctant to let the yuan move more freely against the dollar. It has also deprived China of the easy “seigniorage” profits that come from buying foreign goods and assets in return for non-interest-bearing pieces of paper adorned with portraits of Chairman Mao.

Slowly, however, China seems to be changing its approach. As a result of reforms begun last year, exporters to China

can now price their goods in yuan, rather than dollars, and deposit the proceeds in offshore corporate accounts, mostly in Hong Kong. At first the reforms were a flop, says one banker. Few accounts were opened and not much business done.

Offshore accounts offered puny rates of interest because banks could do so little with the money. But as deposits have grown (see chart), so has the number of firms seeking to tap them. In the past two months McDonald's has issued a yuan-based bond in Hong Kong, as has Hopewell, a property firm. Both were oversubscribed. Banks and the Chinese government itself have also gone to the well.

The off- and onshore markets are still separated by a cliff of controls. Companies cannot borrow yuan from the mainland; they must earn them through trade. Crudely put, yuan flow out of China only if goods or services flow the other way. And offshore yuan do not easily travel back into China either. A currency represents a claim on a country's underlying assets. “The good news is that those assets in China are ever-growing,” observes Ronald Schramm, a visiting professor at China Europe International Business School in Shanghai. “The bad news is that with all the restrictions, there are few ways for outsiders actually to cash in on the claim.”

Last month's decision to let some banks spend their offshore yuan on local Chinese bonds creates another link between these otherwise parallel universes. It will allow some offshore yuan to climb back onshore in exchange for assets rather than goods. These purchases will be subject to a strict quota but still broaden the menu considerably. The onshore bond market is after all worth \$2.9 trillion, 725 times bigger than its nascent offshore rival.

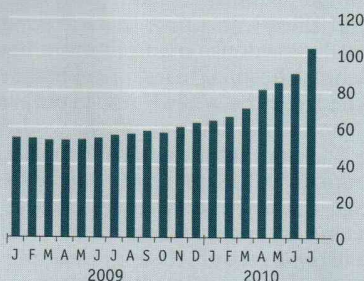
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You're the yuan that I want

Yuan deposits in Hong Kong, yuan bn



Source: Hong Kong Monetary Authority

► If global trade in yuan does swell, international banks have a good chance of developing other fee-generating, predictable businesses, such as handling letters of credit or payments. And since money on its way from one place to another inevitably pauses, there should be more rises in deposits, which become the stuff of loans.

And yet, for all the financial logic, there is a huge argument going on within the Chinese government about whether to proceed. If foreigners sell their dollars to hold yuan instead they will put upward pressure on the currency, making it harder to "manage" (to use the word China prefers) or "manipulate" (to use the word preferred by its critics; see box).

Despite China's capital controls, the offshore market also affords its firms an alternative source of borrowing. Hong Kong, unlike China, allows almost anyone to issue a bond and repatriating the proceeds "is unlikely to be too challenging," notes a report by Standard Chartered. This may erode the architecture of China's credit system, which allows policymakers to channel funds to favoured firms and projects.

Many foreign bankers, and even some government officials, will say these kinds of changes are necessary and inevitable. Some sort of opening up of capital flows certainly seems to be under consideration. But given the potential consequences, there may be far more talk than action. ■

Currencies

Trial of strength

WASHINGTON, DC

Will today's currency interventions hurt or help the world economy?

TWENTY-FIVE years ago this week, the finance ministers of America, Japan, Britain, France and West Germany met at a swanky New York hotel and agreed to push the dollar down. The "Plaza Accord" laid out a package of co-ordinated policies. The dollar duly fell, by more than 50% against the D-mark and yen by 1987. The deal is still seen as a high-water mark of international monetary co-operation. The appeal of intervention is now rising once again. But this time the trend is unilateral, unco-ordinated and in one direction.

At its meeting on September 21st the Federal Reserve worried aloud about uncomfortably low inflation and made clear it was prepared to do more to help the flagging recovery. The prospect of even looser monetary policy pushed the dollar down sharply: it dipped to its lowest level since March on a trade-weighted basis.

A weaker dollar means stronger currencies elsewhere—the euro hit a five-month high against the dollar on September 22nd. A growing number of countries are determined to stop their currencies from rising. Japan sold about ¥2 trillion (\$23.6 billion) on September 15th, its first foray into the currency markets in six years, to stem a surge in the yen that had pushed its nominal rate against the dollar to its highest since 1995. It is not the only rich country to target its exchange rate: in the 15 months to June, Switzerland quadrupled its foreign reserves, to \$219 billion, in a bid to stop the franc from rising too fast.

The most active interveners, however, are in the emerging world. China is the extreme case. It has built up \$2.45 trillion of reserves thanks to its determination to ►►

US-China trade relations

Speak less softly, carry a stick

WASHINGTON, DC

The Obama administration's patience with China wears thin

CHINESE officials like to lecture their American counterparts that, when it comes to loosening their tightly controlled currency, pressure is counterproductive. Tim Geithner, the treasury secretary, has resisted direct confrontation with China over the yuan's value. Like his predecessors, he worries that overt pressure would undermine advocates of reform inside China, principally the People's Bank of China, and erode co-operation on other issues such as Iran and North Korea.

When China said in June that the yuan would be allowed more flexibility, it looked like a victory for Mr Geithner. But as weeks elapsed and the yuan stayed put, the critics began to resurface. "We're all coming to the conclusion that they don't believe we're serious," Jack Reed, a Democratic senator, told Mr Geithner on September 16th. "And as a result, they will listen to you politely but they will not take any effective action."

The administration increasingly appears to agree. On September 15th it brought two actions against China at the World Trade Organisation (WTO): one contesting Chinese duties on American exports of a special type of steel used in power generation, and another over discrimination against foreign providers of payment-card transactions. The previous week the United Steelworkers union asked the administration to sue China in the WTO over subsidies of its renewable-energy industry. America has previously ignored such "Section 301" petitions or settled them bilaterally. But Mr Obama may not hold to that pattern, given his ties to unions and a deadline to respond that falls just before the mid-term elections (extensions can be granted).

Slower burn

China's yuan revaluations
\$ per yuan, announcement date=100



The government's most potent lever, however, is Congress, where numerous bills aimed at punishing China are in the works. The most important is a bipartisan bill pushed by Tim Ryan and Tim Murphy, Democratic and Republican congressmen respectively, that would subject imports benefiting from an undervalued currency to countervailing or anti-dumping duties. The House of Representatives could vote on the bill as early as next week; Senate prospects are less certain. Mr Geithner has been surprisingly open to the proposal, provided it complies with WTO rules (many experts believe it does not). This is a change from the reactions, ranging from ambivalence to hostility, that similar bills have elicited from the White House in the past.

The tougher tone seems to be working. The yuan began rising earlier this month, though it has not yet matched its progress in 2005, the last time China loosened its grip (see chart). America is not likely to ease off. Having at last got China's attention, it is loth to let it go.

Little cause for complaint

Real effective exchange rates*, Jan 1990=100

