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With Chinese economic power ascending, could the yuan assume a new role?

The U.S. dollar has been the world's undisputed international currency of choice for years. However, Chinese officials have begun touting the yuan as the global economy's future reserve currency. To learn more about this development and the possible ramifications, *Global Trade Advisor* interviewed Irene Cheung, RBS trading analyst, Asia Local Markets Trading, Singapore.

How did the U.S. dollar (USD) become the world's dominant reserve currency?

Cheung: The key reason is that the United States is the world's largest economy, accounting for close to one-quarter of global gross domestic product (GDP). U.S. financial markets are also the world's largest with the deepest stock and bond markets, allowing them to attract foreign reserve investments from other countries' central banks.

To be a world reserve currency, an important characteristic is a stable value. In other words, preservation of value is a key requirement, which also means that the country of that reserve currency is expected to pursue sound monetary and fiscal policies to ensure a steady exchange rate. Hence, that country should have a high sovereign credit rating.

How have U.S. exporters and importers benefited from the U.S. dollar's status as a world reserve currency?

Cheung: The USD has become the default currency for international trade settlement. U.S. exporters and importers have enjoyed the convenience of conducting business in their home currency with no foreign exchange risk. Also, having the world's reserve currency, U.S. companies can easily raise funds in all parts of the world at a relatively low cost due to the demand for USD-denominated assets.

What do you make of the reports that China would like to see the yuan become a world reserve currency?

Cheung: There are indications that China would like to be more involved in the international monetary system. This is a natural development as China becomes an increasingly important economic power. Already, China will soon overtake Germany to be the third largest economy in the world, after the United States and Japan.

Currently, apart from the USD, central banks around the world also hold the euro (EUR), yen (JPY) and G10 currencies in their reserves. Hence it follows that with China becoming an important economic power, the role of the yuan should also expand.

And this is occurring. China has recently set up foreign exchange swap agreements in yuan with countries including Korea, Indonesia, Argentina and Hong Kong, totaling some \$100 billion (USD). There are also plans to start some form of a yuan clearing center in Hong Kong, and China and Brazil are planning to conduct bilateral trade in their own national currencies.

What changes would be required in order for the yuan to become a world reserve currency?

Cheung: The yuan was de-pegged from the USD in July 2005. Since then, the currency has been managed mostly in terms of its exchange rate in relation to the USD, though officially a trade-weighted basket is also used as a policy reference.

To become a world reserve currency, one key prerequisite is that the currency needs to be convertible in both the current and capital accounts. In other words, the currency needs to be fully convertible, which is the case for reserve currencies such as the USD, EUR and JPY, but not for the yuan. The yuan is mostly convertible in the current account, but there are restrictions on some capital flows.

How has the global financial crisis impacted China's aspirations for the yuan?

Cheung: It is to be expected that the yuan will play a bigger role in the international monetary system. That said, recent events have brought the issue to a head. The global crisis, with the United States at the epicenter, has caused unprecedented volatility in global financial markets, particularly the U.S. markets. The USD has also been volatile, causing much concern for China, which is the largest investor in U.S. Treasuries with holdings exceeding \$700 billion.

How would the yuan as a world reserve currency benefit China and its trade efforts?

Cheung: If Chinese exporters and importers could conduct their external trade in the yuan, it would eliminate or reduce their exchange rate risk and they would have no need to hedge their currency risks. The benefit is particularly obvious if the USD remains volatile. From the perspective of foreign reserve management, USD depreciation would have a significant negative impact on the value of China's reserves.

How would this potential development impact the U.S. economy and U.S. companies that export and import?

Cheung: First, there would potentially be less demand for USD-denominated assets. Second, the U.S. current account deficit would narrow as capital inflows slow. In other words, the U.S. savings rate could be under pressure to normalize. Third, if the global demand for USD assets does decline, U.S. companies might need to pay higher financing rates.

What is the likelihood of the yuan becoming a world reserve currency? And, if so, how soon could it happen?

Cheung: It is too early to say if this will materialize. One observation is that despite the advent of the EUR, the USD has remained the predominant reserve currency. At any rate, this is a long process that would take more than a couple of years to unfold, and the yuan first needs to become fully convertible.

How can our readers continue to monitor the role of the yuan?

Cheung: There are a few things to watch in the international monetary system. One is potential changes in the International Monetary Fund (IMF) and whether China will play a bigger role in the IMF. Another is possible changes in the Special Drawing Rights of the IMF, in terms of currency composition, etc. On China itself, the key item is the country's progress in making the yuan fully convertible. Lastly, watch for an expanded role of the yuan in bilateral trade arrangements.