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Sooner or later: Central banks eye yuan for reserves

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By Ingrid Melander

LONDON, Jan 14 (Reuters) - Central banks increasingly want to hold yuan as trade with China grows, a move that would boost the currency and turn it into a far greater cog of world finance.

The question is by how much the currency will be bought and over how long a time.

Gary Smith, the global head of official institutions at BNP Paribas Investment Partners -- a firm that manages 54 billion euros ($72 billion) for central banks, sovereign funds and supranational groups -- thinks it will be a lot and soon.

"My estimate of central bank holdings (of yuan now) is 0.5 percent or perhaps even less. My estimate of where we're going to is over 10 percent over the next 3 or 4 years," he said, adding that the uncertainty was timing, not percentage.

"The renminbi (yuan) story will just continue to grow at an exponential pace. We begin from such a small start point and it's such a big story," he said.

Smith's forecast is more bullish than many of his peers, which are generally for a gradualincrease of the world's second biggest economy's closely controlled currency in central banks' coffers.

It would also be a sharp jump from estimates that the yuan, also known as the renminbi, currently accounts for a minimal share of the world's $10.8 trillion reserves.

But there is little argument about the direction of travel.

"There is an important trend there," said Patrick Thomson, global head of sovereigns at JP Morgan Asset Management, which manages $70 billion of assets from sovereign investors.

"The way central banks look at calculating reserves is based on trade balances, so as trade with China grows, they will want to hold more and more renminbi."

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BNP Paribas' Smith bases his forecasts on discussions with central banks he wished to keep confidential, steps taken by China to facilitate foreign central banks' yuan investments and on the fact that private sector payments in renminbi are growing fast.

This, he said, will in turn push central banks to hold more of the currency.

"A lot of central banks hold some renminbi now, all of them in very very small amounts. Every single one will hold more at the end of the year than they do today," he said.

The International Monetary Fund, which monitors central banks foreign exchange reserves, does not publish estimates for the yuan, but says that all currencies beyond the five main ones -- U.S. dollar, euro, yen, British pound and Swiss Franc -- account for only 5.5 percent of known reserves.

The dollar, by contrast, comprises 61.8 percent.

China is the world's largest exporter and second largest economy, but the lack of full convertibility of the yuan, capital controls and the difficulty in getting access to yuan-denominated assets mean it is not an official reserve currency.

It has nonetheless signed currency swap agreements with more than 15 countries, including South Korea. Countries including Indonesia have publicly announced that they are buying bonds on China's interbank market. Nigeria has also said it wants to make the yuan a reserve currency.

Sovereign wealth funds and central banks have also noted Beijing's decision just before year-end to remove a $1 billion limit for them to buy Chinese assets through its Qualified Institutional Investor Programme.

International payments in yuan surged 24 percent in November from the month before, to a record 0.56 percent of global total, transaction services organisation SWIFT said.

But the speed and size of the move remains at issue.

"More and more central banks will start holding modest amounts of renminbi in their reserve portfolio over the next 3 to 5 years," said Eswar Prasad, a Cornell University economics professor and senior fellow at the Brookings Institution.

"But unless the Chinese government significantly steps up its program of capital account liberalisation and unless Chinese financial markets develop rapidly ... I find it difficult to conceive the Chinese renminbi becoming such an important currency in such a short period," said Prasad, a former head of the IMF's China division.

The People's Bank of China said on Friday it would seek to improve the yuan's convertibility but added at the same time that it would step-up monitoring of cross-border capital.