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## Yuan starts on long slog to reserve currency status

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By [Alan Wheatley](#), China Economics Editor - Analysis

BEIJING (Reuters) - It's time for markets to take a deep breath: the yuan will not become a reserve currency, let alone dethrone the dollar, this year, next year or any time soon.

Will China's currency be increasingly used to settle trade in Asia and, who knows, maybe even to denominate commodities? Yes.

Does China worry that lax U.S. monetary and fiscal policy will debase the dollar, today's dominant global currency, and with it a chunk of its \$1.95 trillion stockpile of reserves? Yes.

Does China want to enhance the legitimacy of the International Monetary Fund -- and gain more clout in the process -- by adding the yuan to the basket of currencies that make up the Special Drawing Right, the fund's virtual currency? Yes.

Expect to hear more on these subjects at this week's Group of Eight summit in Italy, which President Hu Jintao will attend.

But conflating these considerations into the conclusion that China is ready, economically or politically, to do what is needed to turn the yuan, also known as the renminbi (RMB), into a reserve currency is wide off the mark.

"The renminbi will clearly internationalize significantly over the next 5-10 years. Over a longer period (10-20 years) it may emerge as a secondary reserve currency like the Japanese yen, although this is not certain.

"For it to replace the dollar as the main global reserve currency would require many decades and a combination of improbable events," wrote Arthur Kroeber in the China Economic Quarterly, a journal he edits.

Kroeber rightly draws a distinction between facilitating the use of the yuan as an international currency for current account purposes such as trade and tourism and enabling its use on the capital account for portfolio investment and reserve holdings.

For that, China would have to scrap capital controls: central banks and other foreigners would have to be able to invest freely in onshore yuan financial assets such as stocks, bonds and bank deposits and to freely repatriate their capital.

For foreigners to hold yuan on a large scale, Kroeber writes, they would also have to be convinced China's markets are trustworthy and fairly free of rigging by the government.

"Technical difficulties aside, this will require a significant retreat from the current state-dominated model of credit allocation. This cannot happen quickly," he concludes.

### LOTS OF DOUBTS

Brendan Kelly, an analyst with Pacific Forum CSIS in Honolulu, agreed that completely eliminating capital controls was a policy transformation that would clash with the ruling Communist Party's craving for control.

"Investors would also likely require significant reforms in the rule of law, raising the question of whether an authoritarian government could ever gain the trust required to be a reserve nation," he wrote in a study.

Furthermore, Kelly doubted whether China had the deep, liquid capital markets that money managers demand of a reserve currency, a shortcoming that he says helped stunt Japan's international ambitions for the yen.

"Significant further development of China's bond markets over the upcoming decades will be required to support a role for the yuan as a reserve currency," said Kelly, a former China country director for the U.S. secretary of defense.

On the positive side of the ledger, Kelly reckons a currency acquires credibility through trial by fire.

As such, he mused, historians may look back on China's stable economic performance and the steady hand of its policymakers during the current turmoil and the 1997/98 Asian financial crisis as building blocks of Beijing's reputation and leadership.

## PARADOX

Eswar Prasad, a Cornell University professor of trade who used to head the IMF's China desk, said China's sheer economic size would propel the yuan to reserve currency status.

"If they can get the technical part fixed up -- having a more convertible currency, deeper financial markets -- even if they do not do very well in terms of institutional factors such as the rule of law, they can in fact end up having the RMB become a major reserve currency," Prasad said in Beijing last week.

The key question, he said, is whether Beijing is willing to live with the exchange rate volatility that an open capital account generates.

This exposes the Beijing paradox. While logic dictates that a reserve currency must rise and fall with the flows of global capital, China has tightened, not relaxed, its grip on the yuan.

"The Chinese authorities view convertibility as quite feasible over a five-year horizon, but the financial crisis has shifted that to some extent," Prasad said.

Worried about export job losses, Beijing has prevented the yuan from appreciating against the dollar for the past 12 months.

"China's stated aspirations -- to have the yuan play more of an important role in international finance, for Chinese companies to go abroad and invest -- are consistent with a gradual opening of the capital account, and in practice that has to go hand in hand with more flexibility of the exchange rate," said David Dollar, who ran the World Bank's Beijing office until last week.

Joseph Yam, who heads the Hong Kong Monetary Authority, hopes the yuan will become fully convertible so it can play the role of a regional monetary anchor alongside the dollar and the euro.

"The possibility of it becoming a reserve currency is there. I think that is one reason why certain steps have been taken in mainland China to promote the greater use of the renminbi internationally. It's early days yet, but I think they are taking the right moves," Yam told Reuters during a recent meeting of the Bank for International Settlements in Basel, Switzerland.

(Additional reporting by Tamora Vidaillet in Basel; Editing by Mathew Veedon)

(\$1=6.83 yuan)

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