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China Focus
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Moving Up in the World

The signs are good for the internationalization of the Chinese yuan, but it still has a long way to go By Deng Yaqing

After continuous appreciation in 2017, China's currency, the yuan, has maintained this trend into the new year, boding well for its long-term target of internationalization.

According to statistics from China's State Administration of Foreign Exchange, in January 2018 the yuan witnessed its central parity rate gain 3.1 percent against the U.S. dollar—more than half the 5.81 percent increase seen across the whole of 2017, which itself marked the most drastic annual appreciation seen in the past nine years.

"The weakening of the U.S. dollar and Chinese authorities' reinforcement of supervision over capital outflow, such as overseas mergers and acquisitions, are two causes behind the strengthening of the yuan, but a robust Chinese economy is the major driving force," Xu Hongcai, Deputy Chief Economist of the China Center for International Economic Exchanges, told *Beijing Review*. China's economy expanded 6.9 percent last year, well above the government's annual target of around 6.5 percent, marking the first pickup in pace in seven years.

"As China's economy continues to move forward, the yuan's internationalization will be achieved, but it will be a long, slow and uneven process," Sun Jie, a research fellow with the Institute of World Economics and Politics under the Chinese Academy of Social Sciences, told *Beijing Review*.

A reserve currency

"In 2017, steady progress was made in the yuan's internationalization, which can be summarized as a return to growth, more solid foundations, enhanced convenience and brighter prospects," said Zhang Qingsong, Vice President of the Bank of China, at a press release of the bank's report on the yuan's internationalization held on Jan. 31.

"The yuan has become the seventh-largest reserve currency in the world, and more than 60 countries and regions now include the currency in their foreign exchange reserves, with the total amount equivalent to over $100 billion," Zhang said, noting that from the perspective of global portfolio optimization, the market demand for yuan-denominated assets looks set to skyrocket in the future.

In June 2017, the European Central Bank announced the exchange of 500 million euros' worth of U.S. dollar reserves into yuan securities. In January, the Bundesbank, Germany's central bank, also decided to hold some currency reserves in Chinese yuan as part of its long-term strategy.


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Attendees discuss the opening up of China's financial market and the yuan's internationalization on the European-Chinese Banking Day of Euro Finance Week in Frankfurt, Germany, on Nov. 15, 2017.

"The presence of the yuan in foreign exchange reserves is real but unimpressive. Actually, the figure has been on the decline due to stricter capital control," said Xu.

According to data released by the IMF at the end of September 2017, for the first three quarters of last year the yuan accounted for 1.12 percent of foreign exchange reserves worldwide, compared with 63.5 percent registered by the U.S. dollar.

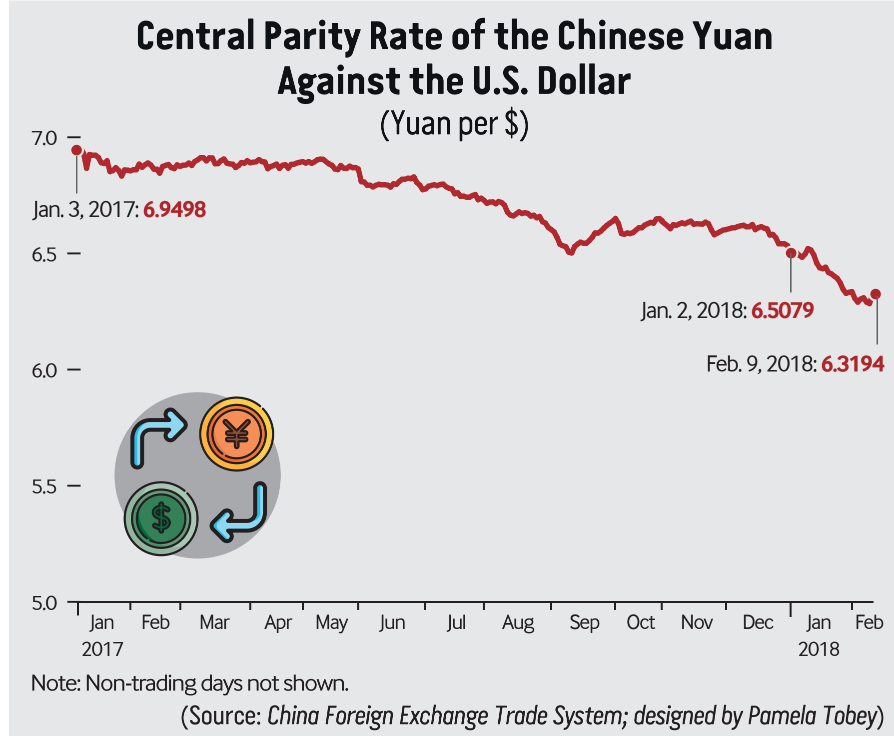
Zhang also said that the yuan's international status lags behind the global status of the Chinese economy.

"China's GDP makes up more than 15 percent of the world total, while its foreign trade and international investment contribute more than 11 percent combined. Therefore, there is huge potential for the yuan's internationalization," said Zhang.

More cross-border use

In order to facilitate mutual exchange, the Chinese Government has launched a series of policies to boost the convenience of cross-border yuan use. Macro-prudential management policies have been unveiled to lubricate cross-border financing, making it more convenient for domestic institutions to borrow offshore funds, and clarifying the business procedures of overseas institutions entering the domestic bond market.

As of the end of 2017, over 250,000 enterprises and 245 banks have been engaged in cross-border yuan transactions, while 195 countries and regions have conducted cross-border yuan receipt and payment with China, according to statistics from the People's Bank of China (PBOC).



In 2017, the yuan settlement of current accounts and cross-border direct investment totaled 6 trillion yuan ($948 billion), with the Chinese currency now ranking sixth globally for payments, accounting for 1.75 percent of the world's total.

In January, the PBOC published a notice on improving cross-border yuan business policies to facilitate trade and investment, which has increased cross-border yuan use by promoting transnational direct investment, personal settlement and business innovation.

According to the Bank of China report, among the surveyed 3,134 industrial and commercial enterprises and 118 financial institutions at home and abroad, 76 percent believe that the yuan is likely to catch up with the U.S. dollar, euro, pound and yen as an international currency, while more than 60 percent suggested that they would begin to use, or elevate the use ratio, of the yuan.

"This is testimony that the global financial market and real economy are demanding the international use of the yuan," said Zhang.

The report also shows that 74 percent of the surveyed foreign companies have conducted cross-border yuan receipt and payment, and 25 percent also have yuan-denominated assets or liabilities.

Gaining momentum

"In the future, the yuan's internationalization will usher in a new round of acceleration," said Zhang, who explained that the process is likely to be driven by three factors.

First, the Belt and Road Initiative has provided important opportunities to expand the use of the yuan, as developing economies along the routes are thirsty for capital, imports and exports, according to Zhang.

Meanwhile, progress has been made in opening up the onshore financial market, and space has been created for the cross-border use of the yuan, said Zhang.

In order to correlate with the inclusion of the yuan in the IMF's special drawing rights basket, the PBOC has put forward a series of policies to improve the connections between domestic and overseas financial markets, such as launching the Bond Connect and Stock Connect programs between the mainland and Hong Kong.

During British Prime Minister Theresa May's visit to China from Jan. 31 to Feb. 2, Chinese Premier Li Keqiang revealed China's preparations for the establishment of the Shanghai-London Stock Connect, expected later this year.

China's crude oil futures, to be launched on March 26, will also boost the yuan's global use. The yuan-denominated oil contract means that the Chinese currency will play a greater role in trade between China and other oil-producing countries.

"Against the foil of low interest rates in the global market, the relatively high returns on yuan-denominated assets will attract more global funds into the domestic capital market, which will allow the yuan to play a larger role as a reserve currency," said Zhang.

According to Zhang, further exploration into the offshore financial market will provide more channels for the yuan to flow globally. As international financial cooperation continues, and the yuan settlement mechanism and the arrangement of bilateral currency-swap agreements make steady progress, and as offshore yuan settlement upgrades and transforms, offshore market players will be more actively engaged in innovating yuan products, he said.

"Hong Kong should better play the role of pivot in order to roll out China's network of offshore yuan centers and the associated network of financial institutions, which is important to achieve internationalization," said Xu.

Sun believes that a vital factor for the yuan's internationalization is China's economic fundamentals.

"Reviewing the internationalization process of other currencies, such as the U.S. dollar, pound and yen, you will find it was subject to GDP growth, foreign trade, inflation and the development of the respective financial markets," he said.

Sun added that one prerequisite for the yuan's internationalization is the opening up of capital accounts, because there would be huge demand from overseas yuan holders to invest in yuan-denominated assets.

Xu agreed that the future of the currency's internationalization lies in the further opening up of China's capital accounts, and by realizing free convertibility.

"Right now the necessary conditions are still not in place, so full opening up at this stage may lead to massive cross-border capital flows, which justifies the strengthening of regulation by the Chinese authorities," said Xu. ■

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