The Economist

Trading the yuan

Yuawn

Buzz about the rise of China's currency has run far ahead of sedate reality

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IF HEADLINES translated into trading volumes, the yuan would be well on its way to dominating the world's currency markets. It once again graced front pages this week after moves to lift its status in London, the world's biggest foreign-exchange market. This was the latest instalment of a five-year-long public-relations campaign. Since 2009, when China first declared its intention to promote the yuan internationally, a string of announcements and milestones has cast the Chinese currency as a putative rival to the dollar.

The hype rests on several seemingly impressive numbers. Yuan deposits beyond China's borders have increased tenfold in the past five years. The "dim sum" bond market for yuan-denominated debt issued outside China has gone from non-existence to a dozen issuances a month. And the yuan is the second-most-used currency in the world for trade finance.

Adding to the impression that something big is afoot is the competition between cities around the world to establish themselves as yuan-trading hubs. London puffed up its chest this week after the Chinese government designated China Construction Bank as the official clearing bank for yuan-denominated transactions in Britain and agreed to launch direct trading between the pound and the yuan in China. These announcements were made to coincide with a trip to London by Li Keqiang, China's prime minister (pictured above).

The designation of a clearing bank creates a channel for yuan held in Britain to flow into Chinese capital markets, boosting London's appeal as a trading centre for the currency. Other cities such as Frankfurt and Singapore have also been awarded clearing banks, but London already controls nearly 60% of yuan-denominated trade payments between Asia and Europe, and this week's agreement will shore up its position.

London's currency traders, however, will not be hyperventilating. The rapid growth in the use of the yuan outside China, whether for trade settlement or investment, has been from a minuscule base. The yuan is the seventh-most-used currency in international payments, according to SWIFT, a global transfer system. That is up from 20th place at the start of 2012. However, the Chinese currency still accounts for a mere 1.4% of global payments, compared with the dollar's 42.5%. Given that many of those deals just shuffle cash between Chinese companies and their subsidiaries in Hong Kong, there is much less than meets the eye to the yuan's stature as a trade-settlement currency.

Even more telling is the yuan's standing as an investment currency. The dollar's biggest selling point as a global reserve currency is the deep, liquid pool of American assets open to international buyers. Despite the barrage of reports in recent years about the dim-sum bond market, China's offerings are much sparser. Jonathan Anderson of Emerging Advisors Group calculates that global investors have access to $56 trillion of American assets, including bonds and stocks. They can also get their hands on $29 trillion of euro-denominated assets and $17 trillion of Japanese ones. But when it comes to Chinese assets, just $0.3 trillion or so are open to foreign investors. This puts the yuan on a par with the Philippine peso and a bit above the Peruvian nuevo sol, Mr Anderson notes.

What is holding the yuan back? The answer is China itself—both by circumstance and, more importantly, by design. For a currency to go global, there has to be a path for it to leave its country of origin. The easiest route is via a trade deficit. For example, since the United States imports more than it exports, it in effect adds to global holdings of dollars on a daily basis. That does not work for China, which almost always runs a large trade surplus. It has tried to solve this problem by offering to pay for imports in yuan, while still accepting dollars for its exports.

Yet this approach can go only so far, because of the design of the Chinese system. Foreigners paid in yuan cannot do much with the currency and thus look askance at it. China could change this at a stroke by flinging open its capital account. There is speculation that it might do just that as debate about financial reform intensifies in Beijing. But Yu Yongding, a former adviser to the central bank, predicts that caution will prevail, with the government slowly lowering its wall of capital controls rather than demolishing it. That would be far better for China's financial stability. But it also means that the chasm between the hype about the yuan and the mundane reality is likely to widen.

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