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China Stumbles in Yuan Grand Plan

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Abstract (summary)

Chinese economist Yu Yongding, a former adviser to the People's Bank of China, recently told a Chinese newspaper that "to date, renminbi trade settlement hasn't helped Chinese companies reduce foreign-exchange risks, but has helped foreign companies cut risks."

Full Text

BEIJING -- When China announced a flagship program to make its currency more international in the summer of 2009, it cited "the growing call" from Chinese trading partners to use the yuan in cross-border transactions. More than a year later, the People's Bank of China touted the program as a "breakthrough," citing a surge in the amount of trade in the currency.

Not everything went according to plan.

The move had unintended side effects, including giving companies and investors a way to profit from the difference in interest rates between China and other countries, and opening a path for "hot money" to flood the country.

It also has boosted, rather than reduced, the amount of foreign-exchange reserves piling up in China's coffers -- the opposite of what Beijing intended when it opened the yuan for foreign trade.

This, in turn, could add to China's already difficult battle to tame an inflation rate running at more than 6%, as the central bank needs to print more yuan to buy up the dollars flowing into the country.

China's stumbles in trying to get its currency more widely accepted outside its borders underline a fundamental contradiction at the heart of Beijing's plans: The Chinese authorities want to keep a tight grip on the value of the yuan to keep exports booming, while at the same time encouraging more foreign companies and investors to use it.

China is trying to blunt the rise of the yuan by keeping its appreciation sharply controlled, but the internationalization program puts upward pressure on the currency.

There is a "tension in the short run between managing yuan appreciation and increasing the yuan's prominence in global trade and finance transactions," says Brookings Institution China scholar Eswar Prasad.

On Tuesday, the People's Bank of China said foreign-exchange reserves jumped by $153 billion in the second quarter to $3.2 trillion.

Of that increase, $48 billion, or about a third, was attributable to China's decision to allow the yuan to be used in foreign-trade transactions, estimates Zhu Chaoping, head of research at ChinaScope Financial, a market-research firm in Hong Kong.

In the prior two quarters, the trade program added a total of $83.5 billion to China's reserves, Mr. Zhu calculates.

China had hoped that allowing the yuan to be used more freely abroad would boost demand for the currency, also known as the renminbi or RMB, and reduce the amount of dollars entering the country.

For the long term, China wants to turn the yuan into a global reserve currency that is used for investment, trade and loans, as are the dollar and euro.

A widely accepted yuan could help Chinese companies alleviate foreign-exchange risks. Chinese exporters, in particular, fear the yuan's continued appreciation against the dollar -- a rise China's leaders have tried to restrain -- would expose them to losses if they can be paid only in greenbacks that have been steadily losing value.

The yuan is widely seen as undervalued, so only overseas sellers are interested in the trade.

Nearly 90% of cross-border trade settled in yuan in the first quarter -- totaling 360.3 billion yuan, or 7% of China's total trade -- involved China's imports, according to data provided by the People's Bank of China, a sign foreign demand for yuan hasn't picked up much.

Shanghai Flying Horse Imports & Exports Co., a state-owned company that exports clothing and textiles, is among the first batch of companies in the city authorized to use yuan to settle trade.

Still, nearly all of the company's exports are settled in dollars, according to Mao Xiaohua, a manager at Shanghai Flying Horse.

"Renminbi settlement certainly would be good for us because that would reduce our foreign-exchange risks," Ms. Mao said. "But our customers in Europe and the U.S. are all unwilling to pay in renminbi . . . . It seems that they totally dismiss the idea of renminbi settlement."

The fact that importers are using yuan means that dollars build up at a more rapid clip in the Peoples Bank of China's vaults because importers don't need to tap them.

"Everyone thinks there is a one-way bet on which way the currency will move," so only those that get paid in yuan are interested in the business, says University of California at Berkeley economist Barry Eichengreen. "When you internationalize, you can't control all the uses to which money is put."

Chinese economist Yu Yongding, a former adviser to the People's Bank of China, recently told a Chinese newspaper that "to date, renminbi trade settlement hasn't helped Chinese companies reduce foreign-exchange risks, but has helped foreign companies cut risks."

Some companies also have used the trade-settlement program to profit from the difference between higher yuan interest rates in mainland China and lower U.S. dollar rates in Hong Kong, according to bankers and analysts.

Such transactions could be used by speculators betting on the yuan's rise and have the potential effect of adding to China's dollar reserves.

Asia Pulp & Paper Co., an Indonesian paper maker, recently directed its Hong Kong subsidiary to borrow U.S. dollars at low rates, using its yuan deposits as collateral, says a person familiar with its operations.

APP then took the dollars and paid for goods produced by its mainland subsidiaries, effectively using low-rate U.S.-dollar loans instead of higher-rate yuan loans.

At the end of a complex series of transactions, APP was able to repay the dollar loans with yuan obtained from the internationalization program.

APP benefitted in two ways: It borrowed in dollars at low rates and paid off the loan with yuan that had appreciated in value since the beginning of its dealings.

APP declined to comment.

Li Bo, director of the Chinese central bank's currency policy division, said in an April speech that the goal of the cross-border yuan program was to help Chinese companies reduce foreign-exchange risks and to ease trade and investment across borders.

People's Bank of China officials declined to comment for this article.

Harvard economist Jeffrey Frankel said China is unusual in pressing to give its currency a bigger international role. He said Japan and Germany, after World War II, and the U.S. after World War I resisted such efforts because they worried that their currencies would strengthen and make their exporters less competitive.

For now, China's central bank is struggling to keep up with companies looking to use the internationalization program as a channel for so-called hot money, which can contribute to dangerous bubbles in China's real-estate market and stock exchanges, as investors look to park their money in sectors seen as paying a high return.

The State Administration of Foreign Exchange, the central bank's currency watchdog, has put in place a "special campaign" to crack down on speculative money flows.

This week, the regulator fined Guangzhou Teng Hang Metal Materials Co., of Guangzhou, China, which buys steel scrap from overseas for recycling, for manipulating its import payments.

The company inappropriately deferred payments of $1.3 million, SAFE alleged.

Delaying payments for imports is a long-used tactic by Chinese companies to benefit from yuan appreciation.

Experts on China's foreign-exchange regulations say the availability of yuan settlement has the potential to make this form of arbitrage even more profitable, because companies now have access to even more favorable yuan exchange rates overseas.

The yuan is valued slightly more against the U.S. dollar in Hong Kong than it is on the mainland.

A manager at Guangzhou Teng Hang declined to comment on SAFE's finding and the fine levied by the agency.

"I'm not aware of that," he said.

The SAFE program may be having some impact.

According to UBS AG economist Wang Tao, speculative inflows -- or capital seeking short-term returns -- slowed to $24 billion in the second quarter, from an estimated $90 billion in each of the previous two quarters.

Credit: By Lingling Wei and Bob Davis

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