Experts' View on a Free-Floating Yuan: Slowly but Surely

By JAVIER E. DAVID

The Chinese yuan still has a long way to go before it is fully convertible in international markets, but Bank of China Ltd.'s move to permit U.S.-based trading in the currency is nonetheless a significant development in what is generally seen as its inexorable march toward that status.

On Tuesday, the state-controlled Bank of China told The Wall Street Journal in an interview that it is now permitting U.S. customers to trade the yuan, also referred to as the renminbi. Coming as it did on the heels of a busy year for yuan-related developments, the announcement intensified speculation about Beijing's timetable for a fully convertible currency.

South Korea lifts interest rates in a surprise move, and China's private-equity sector starts to open up. WSJ's Andrew LaVallee speaks to Heard on the Street Asia Editor Mohammed Hadi about these stories.

Many experts, however, see a free-floating yuan as a distant prospect. They see China, the world's second-largest economy, facing several major hurdles before its currency is ready for prime time. Among the problems that still bedevil the Chinese currency: an information loop tightly controlled by the government; the lack of a developed futures market; and the policy-making credibility that must underpin a global currency.

"China is moving ahead on all these fronts, but foreign-exchange markets are decentralized: there are no bureaucrats in FX markets," said James A. Dorn, vice president for academic affairs at the Cato Institute and a China specialist. "The equilibrium value [of the yuan] has to be discovered by the markets, and not some bureaucrat."

Still, China appears to be taking incremental steps toward allowing just that. Over the course of 2010, China expanded the offshore availability of various yuan-denominated instruments, mostly in Hong Kong, where they proliferated rapidly as demand for the currency grew at breakneck pace.

Li Xiaojing, general manager of the Bank of China's New York branch, told the Journal that the bank's goal is to become "the renminbi clearing center in America."

The move toward liberalizing the yuan began in earnest last June, when the government pledged to increase the flexibility of the currency's exchange rate versus the dollar. In July, it opened the currency to trading in Hong Kong, a former British colony that is a draw for international capital and sees daily yuan trading of about $400 million. Finally, in December, a surge in Hong Kong's yuan deposits was coupled with a technical change that allowed banks to make wider use of electronic settlement.

These events were seen as milestones on the road to internationalization of the currency, a goal the Chinese government is believed to aspire to partly for reasons of national prestige but also to slow down the treadmill of reserve accumulation that the current foreign-exchange regime puts it on.

Eventually, the currency would become like other major currencies and would be convertible for capital transactions, not just trade. Currently, large amounts of yuan can be exchanged for dollars only by companies engaged in exports or imports or through strictly controlled investment procedures. For all intents and purposes, China's capital account remains closed.

In a research note last month, Deutsche Bank predicted that the growing ubiquity of the Chinese currency in both trade and investment transactions "should see the yuan become significantly more traded in the years ahead." And according to figures from the Bank of International Settlements, the yuan now accounts for almost 1% of global turnover, a small figure but one that has nearly doubled in the past few years.

The timing of the Bank of China development also places the news in a distinctly political context. Chinese President Hu Jintao is expected to visit Washington next week. While China's currency peg is less of a political football than it was before the midterm U.S. elections last year, the heat is still on for Beijing to accelerate the liberalization of its exchange-rate regime.

Even though Chinese data out this week showed China growing its imports at a faster clip than its exports, it also showed that the country's surplus with the U.S. actually expanded in 2010 by 26.4%, to $181.27 billion.

Persistent concerns about the U.S. fiscal deficit and the euro-zone debt crisis pose an acute problem for China, whose foreign-exchange reserves jumped to a record $2.85 trillion in the latest quarter. According to a report last year by the China Securities Journal, about 65% of that amount is in U.S. dollars, while 26% is in euros, ratios that leave a massive part of China's sovereign savings exposed to what its leaders see as potentially risky credits.

If it were to liberalize its exchange-rate regime, so that the People's Bank of China wouldn't have to repeatedly buy dollars to keep the yuan from rising as it does now, China would slow the growth of its holdings in these foreign assets.

That is putting pressure on China to diversify the country's vast foreign currency holdings. "They have to worry about huge FX reserves that will top $3 trillion this year. They are trying to take pressure off their currency when all signs are that it's going to appreciate," said Cato's Mr. Dorn.

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