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Yuan's Role Grows in Hong Kong

By JAVIER E. DAVID

NEW YORK—Six months after China pledged to increase the flexibility of the yuan exchange rate versus the dollar, there are fresh signs that it is gradually moving closer to a more international role for its currency.


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A man stands near a yuan symbol on a tram in Hong Kong.

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On Thursday, the Hong Kong Monetary Authority said yuan deposits in the city surged to 280 billion yuan ($42.12 billion) at the end of November from 217 billion yuan in the previous month, a sign of strong demand for the Chinese currency in Hong Kong and of a convergence between the territory's open financial system and the mainland economy. HKMA Chief Executive Norman Chan said the yuan market is expected to "develop progressively" in 2011.

Meanwhile, Hong Kong banks introduced a technical change that will make more use of electronic settlement in financial transactions that use the yuan. The primary purpose of the yuan-deposit program, which was introduced earlier this year, is to facilitate trade. But it is also seen as an important early step toward the full internationalization of yuan, which would eventually involve making it convertible for capital transactions.

"This is obviously further integration [with Hong Kong], and movement toward capital-account convertibility," said James A. Dorn, vice president for academic affairs at the Cato Institute and a specialist on China. He predicted Hong Kong and China are 15 years away from using a single currency.

"China, like every other country, does things in its self-interest, but they are going in the direction of the market," Mr. Dorn said. "They want to internationalize the yuan, and this is one way to do it."

Separately, the yuan rose to its highest level against the dollar in a month after the People's Bank of China adjusted its daily target exchange rate upward. Traders took that as a a signal that China would allow a faster rate of appreciation in coming weeks as President Hu Jintao prepares for a visit to Washington in mid-January.

The yuan has risen 2.8% against the U.S. dollar since June 19, when China ended its rigid peg to the dollar. However, U.S. producers complain that the yuan remains far undervalued and that by actively intervening to prevent it from rising, China gives its manufacturers an unfair advantage.

The U.S. Treasury has voiced its concerns to Beijing about its policy, but for the most part takes a hands-off approach.

Supporters of China's approach say that the yuan's current rate of appreciation is more or less in line with that which occurred in the three years before it was fixed during the 2008 crisis, when it gained 20% against the dollar.

However slowly the process may unfold, the prospect of an eventually free-floating yuan triggers a lot of excitement among China-watchers.

In a recent research note, Bilal Hafeez, a strategist at Deutsche Bank, called China's recent creation of an offshore yuan market "likely the most significant change in regime, and could likely see China have a fully open capital account by 2015." Since June, China has made currency-swap agreements with eight countries, with many now able to invoice and settle trades in yuan.

Economic developments in the U.S.—including a widening budget deficit and loose monetary policy from the Federal Reserve—have spurred China's determination to diversify its $2.65 trillion in foreign-exchange reserves, most of which are in U.S dollars.

Fears of a potential bond-bubble bursting, partly stoked by a recent jump in U.S. Treasury yields to seven-month highs, are also seen as encouraging China to turn the yuan into an international currency and in turn reduce the need to accumulate dollars.

But capital-account convertibility would make the yuan subject to the vagaries of market forces. Currently, China uses rigorous capital controls to dissuade speculative flows. Most analysts don't see that changing anytime soon, especially as the government wages a battle against surging inflation.

With China also now fostering a yuan-denominated bond market in Hong Kong, its latest steps toward liberalization have surprised some observers with how open it is becoming to adjusting the existing regime. And yet by far the biggest changes are still to come.

"Nobody would have predicted this 10 years ago," the Cato Institute's Mr. Dorn said. "This is the tip of the iceberg."