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Ex-IMF China Offl Yuan Becoming A De Facto Reserve FX In Asia

BEIJING (MNI) - The Chinese yuan is on the way to becoming a de facto global reserve currency in Asia at least even as the country's capital account is likely to remain closed for the foreseeable future a former top International Monetary Fund official covering China told Market News International Thursday.

Eswar Prasad a Cornell University professor and former head of the IMF's China Division said following meetings with Chinese government officials here that Beijing is mindful that capital account convertibility is a key criterion to meeting a longer-term goal of making the yuan a reserve currency.

But he said that easing restrictions on the use of the yuan in trade transactions will increase the spread of the Chinese currency in the region at least increasing its role internationally.

"The Chinese may be able to have it both ways by not having a fully convertible currency but one that is important enough in international transactions that it becomes a de facto reserve currency in the Asia region" said Prasad who was also head of the IMF's Financial Studies Division.

Although Prasad said that officials he spoke with don't see the yuan becoming fully convertible for at least a decade the gradual erosion of capital controls mean that the capital account could be "de facto substantially open" within five years.

The People's Bank of China announced Thursday that overseas banks are now permitted to buy and borrow yuan for trade settlement purposes at the same time publishing detailed rules on the use of the currency in foreign trade settlement.

The question of yuan internationalization is tied to the broader issue of the dollar's role as the anchor of the global monetary system.

Chinese officials believe that the world's reliance on the dollar has left it susceptible to the vagaries of Washington policy-making resulting in the kind of instability that led to the near-collapse of the global monetary system at the end of last summer.

Prasad said that China is actively seeking to table discussions in multilateral forums about the dollar as a reserve currency because of its longer-term concerns about depreciation and the impact that this will have on its sizeable foreign exchange reserve portfolio.

Chinese Vice Foreign Minister He Yafei said earlier Thursday that a discussion at the upcoming Group of Eight (G-8) summit meeting about the reserve currencies underpinning the international monetary system would be "nothing strange"

"In the short-term there's no alternative to the US dollar and they know it. They're frustrated by it" Prasad said.

This lies behind the government's push of the yuan for global trade transactions. Thursday's announcement by the PBOC followed earlier steps to internationalize the currency including the extension of a total of CNY650 billion (\$95.2 billion) in currency swaps with emerging market central banks.

For now the yuan's attractiveness lies in regional trade flows Prasad said.

"If you're sitting in a bank in New York with yuan it won't do much good but if you're sitting in Cambodia or Vietnam then the appeal is quite considerable" he said.

"If it gets easier to hold yuan and provide it for settlement in trade transactions we could start seeing the accumulation of the yuan in the region even before it comes close to being a convertible or reserve currency."

But capital account convertibility is an inevitability as the remaining controls lose their effectiveness with increasing flows of yuan domestically and offshore.

"They know that in the long run (capital account controls) won't be effective but how long that is is an interesting question and their horizon seems to be a decade" he said. "My sense is that it will be much more quick."

The PBOC is being careful to couch references to yuan internationalization in deliberately nationalist terms in order to appease vested interests within the government who are opposed to the exchange rate flexibility that such a policy would require.

China made the yuan fully convertible in the current account in 1996.

A push to make the currency convertible in the capital account before the end of that decade was shelved in the wake of the Asian Financial Crisis.

Chinese monetary authorities have spent the better part of this decade trying to stem speculative capital inflows while maintaining a relatively stable yuan exchange rate against the U.S. dollar.

The Foreign Ministry's He also said Thursday that China hopes that in future "the international monetary system will be diversified. This is the hope of the international community."

Chinese central bank governor Zhou Xiaochuan said in March that the world should consider using the IMF's Special Drawing Rights (SDRs) as a "super-sovereign" currency replacing the dollar as the world's main reserve currency.

The SDR is an international reserve asset allocated to IMF members and its exchange rate is determined by a basket of dollars euros sterling and yen.

While Zhou spoke on a personal basis in March a central bank financial stability report published last week renewed the call for

using the SDR as international reserve currency making it an official request by the Chinese central bank.

beijing@marketnews.com

** Market News International Beijing Newsroom: 86-10-5864-5274 **

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