

The Yuan Grows Up

Untethered from the dollar, it could become a major world currency

Call it one small step for China, one very big step for the world. While it's always hard to see the long-term consequences from a single event, financial historians may mark July 21 as the real start of China's development as a global monetary power. That was the day China offered up a modest revaluation of its currency, the yuan, and said it would begin to adjust the money's value based on a basket of currencies, ending the fixed peg that had been in place since 1994. In itself that's no big deal. Plenty of economies peg their money to a basket of currencies. It's often described as an interim way for a developing country to manage exchange rates with key trading partners -- until it feels comfortable enough to let its currency float freely. In practice, because floating means losing a big chunk of control over the price of money, few countries make it to that last step.

So why is China any different? It's still carefully managing yuan exchange rate movements. Its ultratight capital controls mean money can't move freely into the country -- or out. And it's certainly not interested in making its exports expensive enough to slow down a rip-roaring economy that needs to absorb 10 million new workers a year. So very little in practical terms changed between July 20 and July 22. The reason the move to revalue has attracted so much attention is simple. It involves China, a \$1.6 trillion economy that punches way above its weight when it comes to trade, global commodity consumption, and capital flows.

There's more revaluating to come. China has some \$700 billion in currency reserves, mostly dollars, in its treasury, the second-biggest stash behind Japan's. That gives it a lot of heft in global foreign exchange markets. Unlike tiny Singapore, which also uses a currency basket, when China decides to tinker with the value of its currency vis-à-vis others, it will be felt around the world. Beijing's decision to allow the yuan to rise about 2% against the dollar in July may be only the opening salvo of a carefully managed, multi-tiered appreciation over the next couple of years, although Governor Zhou Xiaochuan of the People's Bank of China (PBOC) denies that. David Malpass, Bear, Stearns & Co. chief economist in New York, expects a 6% gain by the end of 2006 while Nouriel Roubini, an associate economics professor with New York University's Stern School of Business, sees a 10% appreciation of the yuan vs. the dollar in just the next 12 months.

China Talks, Asia Listens

Here's why China's move is a step toward the yuan becoming a major world currency. First, People's Bank now can act like a central bank, not just a foreign outpost of the U.S. Federal Reserve. Until now, PBOC had to stabilize the yuan by buying huge amounts of dollars from exporters in exchange for the Chinese currency every time the dollar weakened -- often in response to Fed moves. It then had to mop up all those excess yuan in the Chinese financial system by selling short-term notes and bonds to banks, or run the risk of a runaway money supply and inflation. Also, China has been powerless to stop its currency from moving in lockstep with the dollar against other major currencies such as the euro and yen. But with a basket system that includes, say, the dollar, yen, euro, and key Asian currencies, it can juggle the weightings to keep its trade competitiveness more broadly in control. The yuan might strengthen against the dollar but fall against the yen and euro. This makes sense, since China trades everywhere -- not just with the U.S. Its biggest trading partner as of mid-2005 was the euro zone, followed by the U.S., Japan, and Southeast Asia.

Second, China now has an arsenal to use against speculators. By not disclosing the contents of its basket, it leaves markets uncertain about the timing of future yuan revaluations. True, in the short term this may open the door to more currency speculation among those expecting a further pop in the yuan-dollar rate. But for the longer term, speculators used to making big and destabilizing one-way bets on the currency based only on dollar movements will need to think twice. After all, Beijing still sets the foreign exchange rate -- not the open market. Big multinationals and Chinese companies with international operations will also need to adjust for more currency risk in the post-peg era. The offshore market for nondeliverable forward currency derivatives used by foreign investors to bet on the yuan's future value has mushroomed in recent years and will surely grow bigger.

Thousands of businesses are sifting through the implications of the Chinese move. So are the nation's Asian neighbors, which already seem to be resetting their clocks to the Chinese sundial. It is no coincidence that Malaysia dropped its seven-year peg to the dollar moments after the People's Bank made its announcement. The Bank Negara Malaysia will now manage the ringgit against a basket of key currencies that include the yuan, dollar, euro, Japanese yen, and the Singaporean, Australian, and Canadian dollars.

"Radical Move"

Following the move by China to bolster the yuan, the Monetary Authority of Singapore reaffirmed its commitment to maintaining its own currency's strength. What's more, the Thai baht, Indonesian rupiah, Korean won, and Taiwan dollar have all registered gains since the yuan-dollar decoupling. UBS Securities estimates Japan, Taiwan, Malaysia, Singapore, and Korea have kept their currencies undervalued against the dollar by 10% to 15% over the last year. Now that China has allowed the yuan to appreciate, it gives them breathing room to follow suit without worrying about losing price competitiveness. "It was a radical move if you look at the impact on Asian currencies," says NYU's Roubini.

Will all this turn the yuan into a super-currency soon? No, but to be a true global player you need economic power, global ambitions, and the willingness to trade your currency freely. China has the first two requirements in spades. Slowly, it is working on the third. With so much intra-Asian trade being driven by China, its notes have begun to emerge as a key proxy currency for regional central banks. China's growing trade clout may also mean mainland companies will no longer be willing to pay for 80% of its trade in dollars. Instead, they may insist on being paid in yuan -- and let the other party worry about exchange risk. Longer term, the yuan may catch on as a viable dollar alternative among Asian central banks in a way Japan's yen never did. "Within a year or two, many Korean and Chinese companies will use the yuan and the won to settle trade between them," says Hwang Yoon Jin, senior researcher at the state-funded Korea Institute for Industrial Economics & Trade.

But to really get yuan circulating internationally -- and hence qualify as a big league currency -- Beijing will need to lift its ban on investment by private Chinese citizens in overseas stocks, bonds, and real estate. Until then, the yuan shift by Beijing will look like a very modest development. Yet in the fullness of time, the death of the yuan-dollar peg may well be remembered as a defining moment in China's economic ascendancy. The age of the yuan may come sooner than anyone thinks.

By Brian Bremner, with Chester Dawson in New York, Assif Shameen in Singapore and Moon Ihlwan in Seoul