Headline: Why Yuan Won't Displace The Dollar
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Why yuan won't displace the dollar

BY IVAN PNG

LAST July, China's central bank, the People's Bank of China, took another step towards internationalising its currency, the yuan.

The central bank permitted businesses in Shanghai and four cities in Guangdong province to settle import and export transactions with trading partners in Hong Kong, Macau and Asean in yuan. People's Bank vice-governor Su Ning explained the objective as being to "help mainland companies avoid exchange rate risks, and boost (China's) trade with Hong Kong and Asean".

Settlement in yuan would certainly benefit Chinese businesses. To the extent that their costs are yuan-denominated, receiving yuan for export sales would enable them to avoid foreign exchange risk. And to the extent that their sales are yuan-denominated, paying in yuan for imports would enable them to avoid foreign exchange risk.

But would settlement in yuan benefit Asean businesses – and specifically, Singapore businesses? Will the yuan become the currency of choice for trade in the region?

Despite its phenomenal growth, China is still not Singapore's largest trading partner. The Republic's top ranked trading partner is Malaysia.

In 2008, Singapore's trade with Malaysia totalled $111 billion. Yes, Singapore's trade with China is growing faster than its trade with any other country, but it is still 22 per cent less than Singapore's trade with Malaysia.

To the extent that Singapore's exports to China include domestic value-added and imported items that are denominated in local or other non-yuan currencies, Singapore businesses would still be exposed to exchange rate risk if they were to receive yuan for export sales. Similarly, to the extent that Singapore's imports are sold in non-yuan currencies, Singapore businesses would still be exposed to exchange rate risk if they were to pay for imports in yuan.

Put simply, so long as the yuan is not Singapore's domestic currency, the settlement of exports and imports in yuan does not necessarily help Singapore businesses. The yuan would be just another international currency – competing with the United States dollar, euro and the yen.

So, the real issue is how good the yuan would be as an international currency. For the time being, it is not very attractive as an international currency. Yes, China is the world's second largest economy – or third, depending on which exchange rate is used.

However, the yuan is tightly controlled by China's central bank. Businesses cannot freely buy or sell China's currency. The People's Bank of China regulates all cross-border financial transactions so as to manage the exchange rate.

In the last 12 months, the yuan has been almost perfectly pegged within a range of 6.82 to 6.86 yuan to the US dollar. Indeed, given such a tight peg, for importers and exporters alike there is almost no difference between settling in yuan as compared with settling in US dollars – in terms of foreign exchange risk.

The big difference between the yuan and the US dollar is liquidity in foreign exchange markets. The market for US dollars is so large and liquid that businesses wanting to convert, say, yuan to Singapore dollars, get better deals through a two-step transaction of first converting yuan to US dollars and then US dollars to Singapore dollars than they would converting directly from yuan to Singapore dollars.

It may seem counter-intuitive that a two-step exchange would be more efficient than a one-step exchange. But in foreign exchange markets, liquidity is all important. The market for exchange to and from US dollars is much more liquid than that in other currencies. Indeed, a quick look at the respective websites shows that DBS, OCBC and UOB do not even quote exchange rates for the Chinese yuan.

So, no, for quite some years more, the yuan will not be the currency of choice for Singapore businesses trading with China and other countries in the region. And it might be many years.

In the mid-19th century, Britain was the pre-eminent global economic, political and military power. The sun, it was said, never set on the British Empire. Not surprisingly, the pound sterling was the world's currency. By World War I, it was clear that the US had overtaken Britain. However, it took another world war for the US dollar to completely displace sterling as the currency of international trade.

History will probably repeat itself: We are not about to change international currencies overnight.

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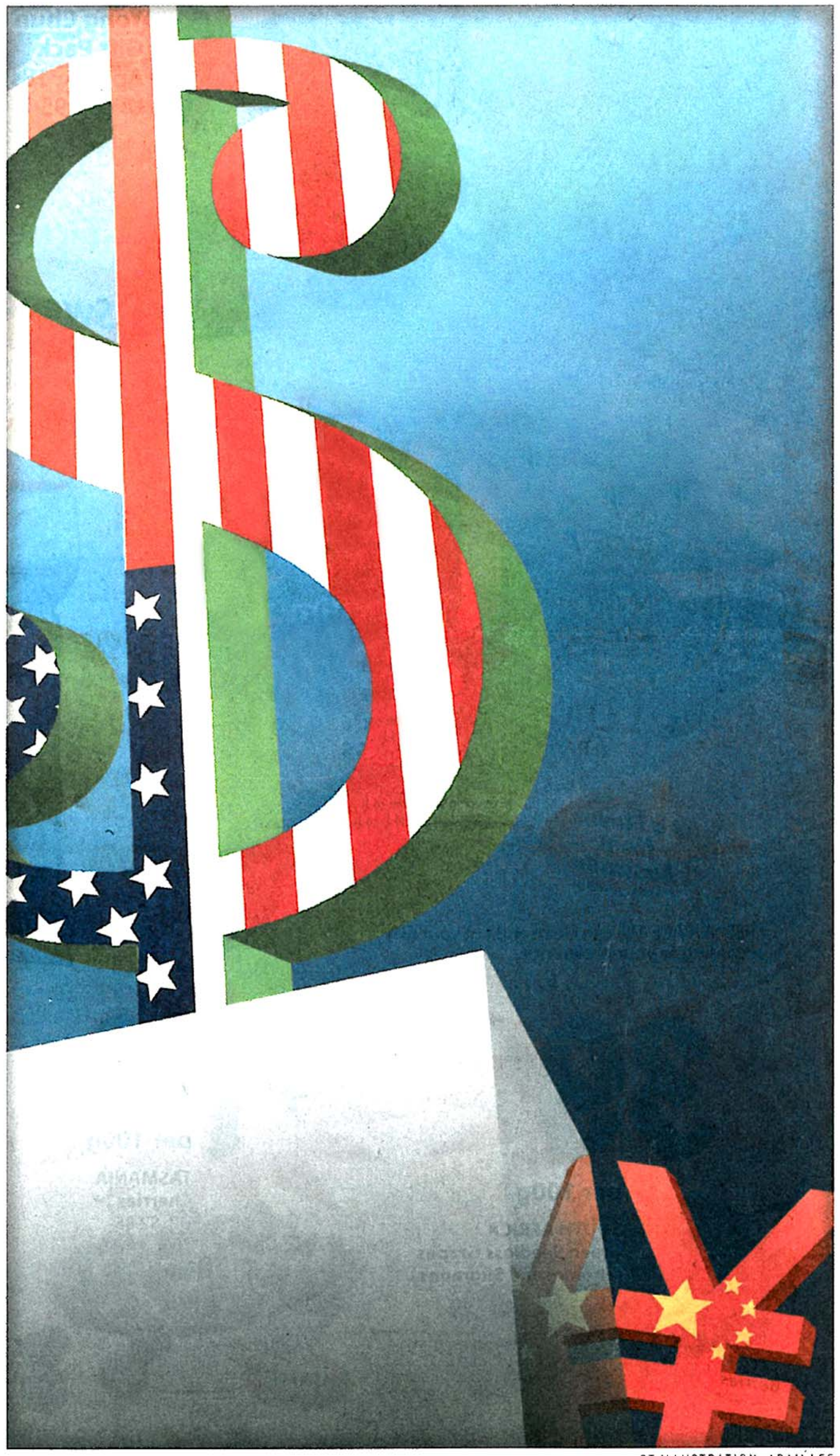

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