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China's yuan: Asia's future anchor currency?

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The yuan is becoming more widely used in pricing and settling intra-regional trade and investment. Asian currencies' movements are likely to shift more in tandem with the yuan, leading to it becoming one of Asia's lead currencies. Singapore is now the world's second-most- important offshore yuan trading hub after Hong Kong.

According to the Society for the Worldwide Interbank Financial Telecommunication (Swift), Singapore last month handled 22 per cent of global payments in yuan, excluding those international payments handled by Hong Kong.

The offshore yuan clearing centre in Singapore is now one of the key drivers of increased yuan usage outside of Hong Kong. Singapore's role as an international financial centre based in Asia has played a key role in enabling it to be a regional gateway for the currency.

Apart from encouraging the use of yuan to settle cross-border trades and financial deals, China has taken other pro-active steps to broaden the international use of its currency since 2009.

For instance, it has facilitated the issuance of yuan-denominated financial products such as "dim sum" bonds.

One significant change is that offshore banks and central banks are now allowed to invest in China's interbank bond market.

This, along with the implementation of the yuan Qualified Foreign Institutional Investor scheme, has widened the investment channels for yuan recycling to China.

Foreign firms are now more open to accepting payments in yuan, with barriers to invest the currency being reduced.

Asia's new anchor currency?

As the international usage of yuan widens, has it become Asia's anchor currency? After all, trade, investment and financial linkages between China and the regional economies have been strengthening.

During normal times, currencies in Asia have a general tendency to move in sync with each other.

Prior to the 1998 Asian financial crisis, this region was known as a "dollar"? bloc, with most Asian currencies such as the Indonesian rupiah, Korean won, Malaysian ringgit, Philippine peso and Thai baht tracking the US dollar closely.

The Asian crisis led some countries to abandon their de facto peg to the US dollar and most currencies in the region became more flexible.

Nonetheless, various regional currencies continued to benchmark the US dollar after the crisis, so much so that the late eminent international economist, Professor Ronald McKinnon, named this region an "East Asian dollar standard".

Such soft pegging to the US dollar means the individual countries' currency exchange rates against the US dollar remained fairly stable up till the onset of the 2007 global crisis.

Having the US dollar as an external anchor during this period in turn reduced the fluctuations of the currencies against each other within the region.

The stability in the regional exchange rates facilitated trade in parts and components, which is particularly sensitive to exchange-rate volatility.

It could be argued that the management of currency exchange rates contributed to the rapid spread of production networks - the break-up of the production process into geographically separated stages - in Asia.

Meanwhile, the yuan itself was pegged to the US dollar as China had adopted a fixed exchange rate system since the Asian crisis. This gave policymakers in Asia a greater incentive to benchmark their currencies against the US dollar.

However, in July 2005, China abandoned its peg to the US dollar and announced a shift to pegging the yuan to a basket of currencies.

The currency basket comprises the US dollar, the euro, Japanese yen, Korean won, Singapore dollar, British pound sterling, Malaysian ringgit, Australian dollar, Canadian dollar, Russian rouble and Thai baht.

But the weights assigned to these component currencies are not disclosed.

The yuan rose 21 per cent against the US dollar over three years until the global crisis struck.

In response to the global crisis, the yuan was re-pegged to the US dollar from October 2008 to June 2010. Since then, China has returned to a basket peg and has gradually delinked the yuan from the US dollar.

Tracking the yuan or the greenback

To investigate whether the Asian currencies have started to track the yuan instead of the US dollar, economists examined Asian exchange-rate data and estimated the extent of co-movement between regional currencies and the yuan.

For instance, a journal article by Arvind Subramanian and Martin Kessler, both from the Peterson Institute of International Economics, finds the yuan has already replaced the US dollar as Asia's anchor currency.

They reached this conclusion by applying regression analysis to exchange-rate data in Asia.

But this may not be the case.

First, the yuan still remains closely linked to the US dollar in spite of China's exit from the currency peg.

This makes it difficult to separate the individual movements of the two currencies and isolate their individual impact on exchange rates in Asia.

Second, the observed co-movement between the yuan and other Asian currencies could be exaggerated by common shocks they are exposed to in the region.

For instance, the outbreak of a bird-flu epidemic in Asia will lead to a fall in the yuan and other Asian currencies alike. In this case, the weakening of Asian currencies may be misinterpreted as a reaction to the fall in the yuan.

When both these issues are dealt with using appropriate statistical techniques, it is equally possible to argue that the yuan has not replaced the US dollar as Asia's anchor currency.

Increasing influence, monetary preference

But it is important to note that the studies do indicate that the yuan's influence on regional currencies' movements has increased.

For instance, a working paper by Masahiro Kawai of the University of Tokyo and Victor Pontines of the Asian Development Bank Institute finds the weight of the yuan is around 10 per cent in the currency basket of South Korea, Singapore and Malaysia just before the global crisis.

However, these countries assigned a higher basket weight of more than 20 per cent to the yuan after the crisis, even though this is still lower than the weight assigned to the US dollar.

It comes as no surprise that the greenback still exerts substantial influence on exchange rates in the region. Monetary preference tends to be sticky, which confers the US dollar with the advantage of incumbency.

Besides, the US dollar enjoys network effects since economies of scale mean more firms will choose to use a currency that has an extensive transaction network.

It should be noted that notwithstanding the slew of measures taken by the Chinese authorities to internationalise the yuan, the Chinese currency remains tightly regulated. The yuan is currently pegged to a basket of currencies with a trading band of plus/minus 2 per cent.

The yuan may not be the anchor currency in Asia currently but what about in the near future?

As its use in pricing and settling intra-regional trade and investment widens, market forces will tend to increase its co-movements with the Asian currencies.

Indeed, China's central role in Asia's trade production network suggests the yuan will become a regional lead currency.

Nonetheless, concerns about China's economic and political dominance in the region mean it is less likely for the yuan to be the only anchor currency in Asia.

Asian currencies are more likely to benchmark against more than one currency, given their geographically diversified trade patterns.

Similarly, the offshore yuan bank accounts and array of yuan-denominated investment products newly offered by Singapore banks will not likely be the only components in a diversified investment portfolio.

There will likely be more than one anchor currency in Asia in the future.