## China's fascination with currency

Written by Barry Eichengreen Thursday, 13 October 2016 07:56

At the start of this month, China's currency, the yuan, was added to the basket of currencies that make up the IMF's Special Drawing Rights, or SDR. Previously, the SDR had been defined as a weighted average of the US dollar, euro, British pound and Japanese yen. Now that the yuan has been added, it can claim to be one of just five truly global currencies.

Should we care? The Chinese certainly do. In Beijing, where I was late last month, joining the rarefied SDR club was all people wanted to talk about. (OK, truth be told, they also wanted to talk about Donald Trump.)

Seeing the yuan added to the SDR basket was a matter of national pride. It symbolized China's emergence as a global power and it vindicated the Chinese government's efforts to encourage use of the yuan in cross-border transactions, freeing China and the rest of the world from overdependence on the US dollar.

However, the fact of the matter is that adding the yuan to the SDR basket has little practical significance. The SDR is not a currency; it is just the unit in which the IMF reports its financial accounts. Only a small handful of international bonds are denominated in SDRs, because banks and firms do not find this option particularly attractive. The main issuer of SDR bonds is the IMF's sister organization, the World Bank. The IMF itself is not authorized to issue bonds.

The only practical implication of adding the yuan to the SDR basket is that it now becomes a currency that countries can draw, along with the SDR's other four constituent currencies, when they borrow from the IMF. Only time will tell how many wish to do so.

The Chinese argue that the yuan's addition to the SDR basket should be seen in a broader context. It is one of a series of steps to encourage the use of the yuan in international transactions.

This agenda includes negotiating currency-swap agreements, now more than two dozen, between the People's Bank of China (PBOC) and foreign central banks. It also includes designating a Chinese financial institution to provide clearing and settlement services for transactions in yuan in each leading financial center. For example, last month the Bank of

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China was chosen as the official clearing bank for New York. And foreign entities are being authorized to issue yuan-denominated bonds in China itself. Toward the end of August, Poland became the first European government to do so.

However, the reality, again, is that these steps are more about symbolism than substance. The PBOC's yuan swaps are almost entirely unused. Designated clearing banks have not exactly been flooded with business. Offshore yuan bank deposits are falling. The proportion of China's merchandise trade settled in yuan has been declining since the middle of last year. And there is no sign that where the Polish government has so boldly ventured, other governments will soon follow.

The fault, to paraphrase Shakespeare, lies not in the stars, but in China's own financial markets. Since the middle of last year, the country's stock market has been on a roller coaster. Every international organization worth its salt, from the IMF to the Bank for International Settlements, has been warning of problems in China's corporate bond market. And if defaults on loans to corporations are widespread, as these organizations predict, the implications for the banks could be dire.

The problem is mistaken tactics by the Chinese government. The government and the PBOC believe that relaxing capital controls and allowing financial capital to flow more freely in and out of the country will force financial market participants to lift their game. Companies will have to upgrade their accounting standards, and banks their risk-management practices, to cope with the faster pace of financial transactions. The result will be more liquid and stable financial markets, in turn making the yuan more attractive as a unit of account, means of payment, and store of value for residents and foreigners alike.

Unfortunately, assuming a result does not make it so. If Chinese banks and firms are slow to adjust, liberalizing international capital flows will lead only to more volatility, fewer offshore deposits and less reliance on the yuan for settling merchandise transactions — exactly as has been the case recently.

Chinese policymakers must now put the horse before the cart. The most important step they can take to foster yuan internationalization is to bolster domestic financial markets, modernize regulation and streamline contract enforcement. If China wants to transform the yuan into a first-class global currency, it should pay less attention to yuan trading in New York and the

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currency's weight in the SDR basket, and more to the development of deep, liquid and stable financial markets at home.

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