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# Challenges put brakes on yuan internationalization

Renewed momentum possible with Chinese structural reforms



Chinese 100 yuan banknotes © Reuters

China's drive to turn the yuan into a major international currency has slowed amid economic developments unforeseen by the currency's strategic advocates.

Enthusiasm for yuan internationalization peaked in late 2015 when the International Monetary Fund welcomed the Chinese currency into the elite

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basket of currencies that constitutes its special drawing rights. Since then, the yuan's progress has been hampered by its own weakening, slowing economic growth, mounting debt, bank weakness and capital outflows. It is unlikely to regain momentum until these higher priority issues are addressed.

In the run up to SDR membership, Chinese officials declared that the yuan would remain stable and also become more market-driven but these aims have proved contradictory as debt, outflows and slowing growth have come to the fore. Meanwhile, to fulfill its promises, China has revised the way the People's Bank of China sets the daily value and range of movement for the yuan and has spent hundreds of billions of dollars of foreign reserves to stabilize the currency.

After rockiness in the first half of 2016, the yuan indeed remained stable during the second half against a basket of its trading partners' currencies, the proper measure of its equilibrium. But the effect of government expenditures to prop up the yuan have left it above its natural market level. Yet these expenditures have become so large that if downward market pressures continue, they could become unsustainable.

While the yuan depreciated against the dollar during the latter part of 2016, this was caused by dollar strength, not yuan weakness. Doubts though about the stability of the yuan will reduce market participants' willingness to denominate deals in the currency.

## Currency order

China's strategy for yuan internationalization has been audacious.

Western economists prescribe a sequence of prerequisites for the internationalization of a currency. First, the currency must be made convertible, otherwise market participants will not be able to judge its value and a sudden burst of demand could result in a squeeze and instability.

Full convertibility implies an open capital account. For the capital account to be open, domestic bank interest rates must move freely, otherwise market participants may rush in and out of the currency depending on the difference between international and domestic rates, which can result in instability.

If interest rates are freed from controls, then the banking system must be fully stable and well-regulated. If not, banks could become vulnerable to collapse if they have lent too much long term with money borrowed short term.

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