Tuesday September 22, 2009

Will the ringgit be drawn into the field of the yuan?

By DOMINICK C.H. LOW

IF Lord John Maynard Keynes were alive today he would be glowing. Not only have his views about fiscal spending become mainstreamed and widely adopted by policymakers since the arrival of the global financial crisis but even his less-accepted ideas about currencies are gaining, well, currency.

In March, People's Bank of China governor Zhou Xiaochuan put out a paper entitled "Reform the International Monetary Fund", ahead of the G20 Summit in London. In it, he praised Keynes' 1944 proposal for a world currency unit, the bancor, referring to it as "far-sighted".

Zhou said that the time had come to replace the US dollar with a "super-sovereign reserve currency" (he may have meant supra-sovereign), a proposal clearly linked to the IMF's Special Drawing Rights (SDR).

His remarks were supported by Nobel Laureate Joseph Stiglitz, who is heading a UN commission of experts, due to release their report this week.

Despite receiving widespread publicity and the backing of many countries – among them Russia, Brazil, Indonesia, Thailand and Malaysia – the subject of global reserve currencies did not make it on to the G20 agenda.

This, no doubt, reflected yet again the sensitivity of the subject among the developed countries attending the summit.

Predictably, the United States rejected any suggestion that the dollar would head anywhere but up. Zhou himself seemed to be cautious about the prospects of de-dollarisation, noting that "a stable valuation benchmark may take a long time."

Interestingly, US Treasury Secretary Timothy Geithner later in March was reported to have said at a Council for Foreign Relations event that Washington was "open to China's proposal," whereupon the dollar instantly plummeted. He was later forced to retract his remarks.

This is not the first time that the US has had to respond to demands for international financial reform, including the use of the SDR in place of the dollar. Each time these calls seemed to fall on deaf ears.

To say that there have been no changes of the international financial system, however, is incorrect. The creation of the euro in 2002, for example, was an event of massive significance. After much naysaying and despite a rocky start, the euro has gradually emerged to become the world's second most widely held and traded currency.

Since the start of the global financial crisis, China has been quietly but systematically putting massive amounts of yuan where its mouth is.

The significance of this seems to have either escaped notice or been overly discounted by those who are unable or unwilling to conceive a non-dollar-dominated world even though worldwide holdings of dollars have already dropped.

First, and is well known, China is also opening up its market for yuan assets to foreign investors. Under its 2003 Qualified Foreign Institutional Investor (QFII) programme, investors are able to add exchange-traded yuan equity and debt, including sovereign debt, to their portfolios and this is currently in the process of being increased. In June, Bank Negara became a QFII.

Second, in December last year, China signed trade and 650 billion yuan worth of swap agreements with six countries that enable them to settle trades in yuan. Coming at a time of extreme dollar jitters, this initiative was warmly welcomed. Among the six signatory countries were South Korea, Indonesia and Malaysia.

Third, earlier this month, China agreed to invest in 32 billion SDR IMF notes or US$50bil. This is the first time in the history of the fund that this has happened and is unlikely to be the last. China is also urging other countries, notably Russia and Brazil, to subscribe to SDR securities and thereby diversify away from the dollar.

Also early this month, China announced that it would sell 6 billion yuan of its government bonds to foreign investors in Hong Kong. The Ministry of Finance said that this would promote the use of yuan in neighbouring countries and improve its international status.

It is true that many obstacles remain to be overcome if the yuan is to become a powerhouse. These include improving China's domestic capital markets and infrastructure, dismantling its capital controls and allowing full convertibility of the yuan.

This, however, seems to be precisely the direction that the country wants to head towards and so it may only be a matter of time.

There is also the fact that the yuan is not a part of the SDR basket as yet. That basket is presently made up of dollars (44%), euro (34%) and yen and sterling (11% each). Given the size of China's economy, its almost 14 trillion yuan of foreign reserves and with convertibility of the yuan, this too might turn out to be purely procedural.

Will the ringgit be gradually drawn into the gravitational field of the yuan? The answer at this point seems to be "very likely." And going by developments, a multi-polar currency regime, on the road towards a more stable store of value, will be a good thing, not only for the country but the world.

·Low is an intern at the Institute of Strategic and International Studies (ISIS) Malaysia and Wong is ISIS Malaysia's assistant director general responsible for economic policy studies. They can be contacted at lowd2002@gmail.com and steve@isis.org.my respectively.