New Straits Times

**30 January 2012**

# Southeast Asia's yuan dilemma

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Users, however, must be informed and educated

*More countries are now using the yuan or renminbi (right) rather than intermediating through the US dollar.*

THE Chinese yuan (or renminbi, RMB) is rapidly growing as a medium of international exchange. Increasingly, it is also becoming a store of value.

Driven by the growth of the Chinese economy, more countries are using the yuan rather than first intermediating through the United States dollar.

On Dec 26, last year, after a bilateral meeting between Prime Ministers Wen Jiabao and Yoshihiko Noda, it was announced that China and Japan would promote direct trade in yen and yuan, as well as develop a market for companies using these two currencies.

Also announced was a plan for Japan to buy Chinese bonds using its RMB earnings, thereby recycling it back into the Chinese economy.

After the China-Asean Summit in October last year, it was intimated that a Framework Agreement between China and Asean would be signed for the exchange (or swap) of yuan into each of the Asean member countries' currencies.

Indonesia, Malaysia and Singapore already have such bilateral arrangements in place and Thailand will soon join these three.

The China and Japan agreement, however, promises to move the game to a higher level altogether. China-Japan two-way trade is huge at US$340 billion (RM1,020 billion) while Asean's collective two-way trade with China last year was about US$270 billion.

While foreign exchange is driven by commercial and financial realities, there should also be a holistic and realistic assessment of strengths and weaknesses.

Undertaking more yuan transactions means becoming more highly sensitised to decisions taken by Beijing and Chinese policy institutions.

Capital is not free to flow in or leave mainland China, although freer markets exist in Hong Kong. In addition, the yuan is not allowed to rise or fall in an unlimited and uncontrolled fashion.

During times of great economic volatility, such as the 1997 Asian Financial Crisis, these controls, in the hands of wise policymakers, help to ensure a greater measure of currency stability than would otherwise be the case.

But the yuan has also been argued to hurt economies. Many politicians in Washington DC and Brussels, for example, are unhappy at China's "manipulation" of its currency.

Even developing countries such as Brazil and some in Asean, reeling from the onslaught of cheap Chinese imports, have complained about the "low" yuan. This matter is now being considered in the World Trade Organisation.

China's attempt to lessen its problem by using more yuan in transactions is a rational one. And Beijing does recognise that the yuan must be more flexibly managed.

What it does not want to do, however, is hurt exporters, trigger domestic deflation and wipe-off value from its enormous portfolio of US dollar assets.

Countries that are party to the yuan arrangement must realise that China faces policy conundrums in its management of the yuan. The monetary policy instruments and institutions that China has at its disposal are fairly rudimentary and certainly no match for those that govern the US dollar.

A potentially even more dangerous development is that it exposes countries to the structural weaknesses in the Chinese economy. Many have been talked about, but perhaps of most immediate concern is the health of the financial system, particularly that of state banks.

Analysts argue that the latter have caused a massive misallocation of financial resources that could result in their eventual collapse.

To this must be added the possibility of domestic political, social and military risk premiums. As China rises, it is essential that it does all that it can to ensure peace and stability both within and outside the country, including its neighbours bordering the South China Sea.

In short, China's yuan is destined to be an international reserve currency. Given the disruptive effects of the US dollar, this can and should be welcomed.

Countries, however, need to prepare for the greater usage of yuan by ensuring that users (especially private companies) are adequately informed and educated.

Governments need to consult more extensively with China to ensure that the rise of yuan usage is compatible with their and not just China's interests.

The building of these mechanisms, including through Asean Plus Three's Chiang Mai Initiative, would seem to be the next step in the road ahead.