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MARKETS

Why the Yuan Still Has Long Way to Go to Supplant U.S. Dollar



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By **CAROLYN CUI**

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China's yuan will officially join the International Monetary Fund's elite basket of reserve currencies on Oct. 1, a designation that the Chinese authorities had fought hard to win.

But don't expect the Chinese currency to overtake the U.S. dollar any time soon as the dominant currency when it comes to reserve investment. Near-term concerns about China's slow expansion, along with lingering doubts over its leadership would keep many overseas investors from converting as renminbi.



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About a year ago, the IMF agreed to add the yuan to its Special Drawing Rights basket, placing it alongside the dollar, euro, yen and pound. SDR is a reserve

asset that the IMF created to supplement its member countries' official reserves. The inclusion, which will give the yuan a 10.9% weighting, takes effect this Saturday.

Some institutions, including the IMF and the Bank for International Settlements, are expected to increase their holdings of renminbi assets in order to match the new SDR weightings. It is estimated that the two entities, combined, will need to hold around \$60 billion worth of renminbi, according to Eswar Prasad, the former head of the IMF's China division and the author of a new book "Gaining Currency: The Rise of the Renminbi."

Globally, a few central banks, including the Banco Central de Chile and the Central Bank of Nigeria, are believed to hold renminbi in their foreign-currency reserves, with many indicating that they are looking at adding it. The IMF estimated that about 1.1% of the official foreign reserves were held in renminbi in 2014, up from 0.7% in 2013.

Total demand for renminbi is expected to increase by about CNY211 billion, thanks to the allocation change by IMF members over the next few years, said Louis Lu, a portfolio manager of the CSOP FTSE China A50 exchange-traded fund.

"The SDR inclusion has catalyzed certain changes in China," Mr. Prasad said. But eventually, what will determine how much investors are going to put into renminbi is whether China can execute the reforms that it has pledged: to improve financial-market regulations, open up the capital account and make the yuan's exchange rate more market-driven, he said.

So far, China has focused its efforts on making its markets more accessible for foreign investors, with a surprise announcement made earlier this year to liberalize its \$7-trillion interbank bond market. And recently, certain quotas were also removed to encourage foreign purchases of renminbi assets.

But investors are keen to see changes on regulations and the exchange-rate regime before they direct a significant amount of

But the potential is enormous. Foreign investors own about 14% of Chinese currency bonds, compared with about 36% in Mexico and 14% in Korea, according to Apratim Chakravarty, head of Asian Product Distribution, Americas at HSBC.



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Mr. Chakravarty noted that a number of reserve managers and institutional investors have recently set up their accounts in order to buy yuan-denominated bonds. Foreign holdings of Chinese onshore debt rose to the highest level in June, according to the latest available official data.

“We feel there’s a runway for this to increase,” he said. China’s five-year bond yields about 2.6%, compared with about 1.15% in the U.S.

A latest survey by Deutsche Bank showed that global fixed-income investors are looking to increase their holdings of onshore renminbi bonds from the current 5% of their Asian local bond portfolios to almost 13% a year from now, and further to over 26% in five years’ time. The respondents to survey represent an estimated \$14.5 trillion in global assets under management.

“Yuan is on its way to becoming an international currency and it could become a significant reserve currency if China continues with the economic and financial markets reforms,” Mr. Prasad said.

But it has a lot to do catch up to the dollar, a traditional safe-haven currency. “That would require much more fundamental, legal and institutional reforms, and none of those are on the table,” he added.

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