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William H. Overholt: The yuan's transition to international currency hits a wall

China needs to address debt, other more pressing issues first



The yuan's global standing should be one of Beijing's least concerns right now. © 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 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

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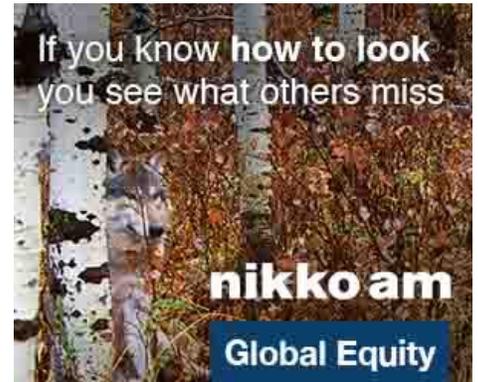
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yuan and has spent hundreds of billions of dollars of foreign reserves to stabilize the currency.

These expenditures have become so large that if downward market pressures continue, they could become unsustainable. In turn, doubts about the stability of the yuan will reduce market participants' willingness to denominate deals in the currency.

REVERSE ORDER China's strategy for yuan internationalization has been audacious.

Western economists prescribe a sequence of prerequisites for the internationalization of a currency to avoid setting off market instability. First, the currency must be made convertible. Full convertibility implies an open capital account. For the capital account to be open, domestic bank interest rates in turn must move freely. If interest rates are freed from controls, then the banking system must be fully stable and well-regulated.

China assumed its stable economic growth and credit conditions would continue and that therefore it could reverse the sequence of prerequisites. The authorities' plan was rather to use yuan internationalization to press for a more open capital account, market-set bank interest rates and other financial reforms.

China did make important progress, particularly on freeing interest rates and starting a bank deposit guarantee system. But its bold approach conflicted with the unexpected reality of pervasive financial weakness and powerful capital outflows.

This weakness stemmed from state enterprise debt, local government borrowings, shadow banking and a bubbly property market. The government kept economic growth high by piling on even more debt, a risky strategy that has led to even more bets on yuan depreciation.

Huge capital outflows came from Chinese enterprises repaying foreign currency debt in fear of yuan weakness; from a reversal of speculative betting on yuan appreciation to betting on depreciation; and from individuals and businesses trying to move money abroad in the face of political uncertainty.

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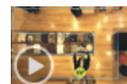
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