Will Yuan Join The Free Trading Party Soon?

Ask any trader on the planet if the Yuan will continue to strengthen and chances are, the answer would be a resounding Yes.

After all, the Yuan has strengthened about 35 percent against the US dollar since 21st July 2005 – the day China removed the Yuan's peg to the greenback and moved into a managed floating exchange rate mechanism.

It has also gained some 20 percent against the euro in the same period.

In November 2013, China's central bank Governor Zhou Xiaochuan made mention of ending normal intervention in the currency market and broadening the Yuan's daily trading limit. Indeed, such talk is fueling expectations of faster Yuan convertibility and liberalization of interest rates. Many market participants have gone even further to suggest that the Yuan would become freely traded soon.

As early as April 2012, the People's Bank of China (PBOC) started reforms to show the world that they were serious in moving the Yuan towards becoming freely traded. At the time, the central bank announced that it would widen the Yuan's daily trading limit against the US dollar to one percent from 0.5 percent. This meant that the Yuan would be allowed to rise or fall by one percent from the central parity rate each trading day. The central parity rate of the Yuan against the US dollar is based on a weighted average of prices before the opening of the market each business day.

According to the PBOC, the widening of the Yuan's trading band aimed to promote the price discovery of the exchange of the Yuan, boost its two-way fluctuation flexibility and improve the market-based managed floating exchange rate regime tied to a basket of foreign currencies.

Here are the top 5 events in 2013 to suggest that the PBOC is serious about moving the Yuan into a freely traded currency soon:

1) Singapore Launches Yuan Clearing Service (May 2013)

ICBC Singapore became the first Yuan clearing bank designated by China in another country, with Hong Kong and Taiwan previously the only places outside of Mainland China with designated RMB clearing banks. This was a significant move because Singapore had been widely expected to serve as a gateway for the use of Yuan in Southeast Asia.

Both central banks in Singapore and China then doubled the size of their bilateral currency swap facility to RMB300 billion and expanded its scope to provide Yuan liquidity to banks in Singapore. According to official figures from the Monetary Authority of Singapore, Yuan deposits in Singapore have grown by about 40 percent since Dec 2012, amounting to just over RMB140 billion as of end July 2013.

2) China Signs Currency Swap Deal With UK (June 2013)

This was the first such agreement between Beijing and a major developed economy outside of Asia. The deal was to setup a three-year swap line with a maximum value of 200 billion Yuan, allowing the Bank of England to draw on the line with the PBOC in the event of shortage of Yuan funds in the UK.

Market participants saw it as a clever way to enhance foreign investors' confidence in trading the Yuan and turn it to an international currency, especially since London was and continues to be the largest Forex trading centre in the world.

3) China Removes Lending Rate Floor (July 2013)

Previously 70 percent of the benchmark lending rate, China announced that they would scrap the lending floor once and for all. The move was aimed at helping to provide companies with cheaper credit, ultimately lowering their financial costs. The move caused stocks to surge, underlying the positive sentiment because market participants had expected the PBOC to gradually lower the rate as opposed to doing away with it altogether. The move was welcomed by international counterparts like the USA.

4) Yuan Enters World's Top 10 (September 2013)

In September 2013, the Bank for International Settlements (BIS) said the Yuan had cracked the top 10 most-traded currencies for the first time, leaping to ninth place from 17th in 2010 while surpassing the Swedish Krona and the New Zealand dollar. Daily trading in Yuan had tripled to USD120 billion in the same period.

5) Yuan becomes Second Most Used Currency After Dollar (December 2013)

The Wall Street Journal reported that China's burgeoning influence on the world economy reached a milestone as use of the Yuan in trade finance overtook the euro and the yen. In fact, as much as 8.7 percent of China's currency was used by both importers and exporters for financing agreements with trade partners in October. This figure was almost double the 4.4 percent a year earlier. This figure put the Yuan above the euro and the yen - at 6.64% and 1.36% respectively, although still well behind the dollar, which backs 81% of trade finance.

In a separate report, the central bank of China itself showed official figures that cross-border RMB trade settlements in the first six months of 2013 totaled 2.05 trillion Yuan, an increase of 60 percent year on year.

Although a rising currency has its advantages, it comes with a price. The export business in China is one example. As the world's largest exporter, any appreciation in the local currency would hurt exporters' profits. This year alone, with the Yuan appreciating 4 percent, export companies which had a profit margin of less than 10 percent would have probably gone out of business.

In conclusion, I foresee that there will be two additional events by the PBOC before the Yuan becomes freely traded around the world. Firstly, an expansion in the Yuan trading band. This could go up to 2 or 3 percent from the current 1 percent. Secondly, a move towards free deposit rates. The one challenge that China has to solve before completely abolishing the fluctuation limit for deposit interest rates is the profitability of the banking industry. After all, 80 percent of their net profits are generated by net interest margins.

Once these hurdles are crossed, the markets can look forward to the Yuan being freely traded on the financial markets.

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