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Japan and China Bypass US in Direct Currency Trade日中，通貨直接取引で米国を迂回

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Japan and China started direct trading of their currencies, the yen and the yuan, on the inter-bank foreign exchange markets in Tokyo and Shanghai on June 1 in an apparent bid to strengthen bilateral trade and investment between the world's third- and second-largest economies.

Direct yen-yuan trades also aim to hedge the risk of the dollar's fall in the long run as the world's key settlement currency and as the main reserve currency in Asia, the world's economic growth center in the 21st century. By skipping the dollar in transactions, the region's two biggest economies indicate their intention to reduce their dependence on dollar risk and US monetary authorities' leeway and prowess on the Asian economy. The move aids China's goal of undercutting US influence in the region while strengthening China-Japan financial ties.

Comparison of Japanese, Chinese and American currency.

This is the first time that China has allowed a major currency other than the dollar to directly trade with the yuan. For Beijing, this new step brings benefits of further internationalization of the yuan. For Tokyo, direct trading confers a favor of incorporating China’s dynamic growth more effectively and economically. The possible future correction of China's still artificially undervalued yuan may also result in a weaker yen, boosting the competitiveness of Japanese exporters such as Toyota and Sony in the long term.

Japan's three megabanks - Mitsubishi UFJ Financial Group, Sumitomo Mitsui Financial Group and Mizuho Financial Group - all began direct yen-yuan trades with major Chinese banks on June 1. Exchange rates between the yen and the yuan are determined by their transactions, delinking the current "cross rate" system in which the US dollar intermediates in setting yen-yuan rates.

"We can lower transaction costs and reduce settlement risks at financial institutions as well as making both nations' currencies more useful and energizing the Tokyo market," Japan's Finance Minister Azumi Jun said on May 29.

China also welcomed the new trading agreement.

"This will help lower currency conversion costs for economic entities, facilitate the use of RMB [the renminbi, another name for the Chinese currency] and Japanese yen in bilateral trade and investment, promote financial cooperation and enhance economic and financial ties between the two countries," the People's Bank of China (central bank) said in a statement.

Direct trading between the yuan and the yen is part of a broad agreement reached during the summit last December in Beijing to reinforce financial ties between Asia's two most powerful nations.

It appears that business is business. The heightened tension between the two nations in recent years did not prevent this new dealing in the financial community, even after China gave Tokyo a diplomatic brush-off, cancelling a string of VIP visits with Japan in the wake of Uighur exiles holding their annual meeting in Tokyo in mid-May and Tokyo Governor Ishihara Shintaro's offer to buy the Senkaku Islands in the East China Sea. The islands, which are part of Japan's Okinawa Prefecture, are also claimed by China. But these tensions did not prevent new development in their currency trading.

Bypassing the dollar

Up until June 1, Japanese and Chinese firms had paid currency conversion fees twice in trade and other bank transactions. Japanese companies first had to convert the yen into the dollar, then they exchanged the dollar for Chinese currency. For Chinese firms, it was vice versa. With this removal of the interim step by skipping the dollar in transactions, many expect cost reductions.

Japan ranks fourth among China's trading partners after the European Union, the United States and the 10-country Association of Southeast Asian Nations (ASEAN), while China has been Japan's largest trading partner for the past three years.

The total share of China and Japan in the world's combined gross domestic product (GDP) was 19.9%, based on purchasing power parity (PPP), according to the IMF World Economic Outlook Report published in April 2012.

Bilateral trade rose 14.3% year-on-year to reach US$344.9 billion in 2011, hitting a new record for the second consecutive year. China accounts for about 20% of Japan's world trade value. Around 50% to 60% of that is being settled in dollars, with less than 1% of it settled in yuan. One Chinese news outlet has estimated direct yen-yuan transactions will realize $3 billion in cost savings.

There are still cautious views on the scale of cost reductions among Japanese market participants.

"Dollar-yen transaction costs are already very low," Karakama Daisuke, market economist at Mizuho Corporate Bank in Tokyo, said. "The cost reduction effect of direct yen-yuan trading should be limited."

No pressure from the US

In the past, the US appeared displeased to see China and Japan forge stronger economic ties with each other. For example, then US Treasury secretary Larry Summers was viewed as a key official involved in spiking Japan's proposal during the 1997 Asian economic crisis to establish an Asian Monetary Fund, an idea put forward by Japan's then-vice minister of finance for international affairs, Sakakibara Eisuke.

More recently, the US opposed the establishment of an East Asian Community, or an economic and political bloc that might become equivalent to the European Union, as proposed by former Japanese Prime Minister Yukio Hatoyama. For the US, it's not a welcome step to see China and Japan unite in East Asia, excluding the US.

"Regarding yen-yuan direct trading, we have maintained close contact with the US government and exchange views sufficiently," an official in charge of foreign exchange at Japan's Ministry of Finance (MOF) said. "We have repeatedly said this is not something that calls for a change in the dollar-centered postwar Bretton Woods system. So there has been no pressure from the US."

The official pointed out that for China, direct yuan-yen trade may have the merit of reducing the risk China faces from a volatile US dollar. The collapse of Lehman Brothers in 2008 and the ensuing financial crisis caused the dollar's value to plunge, leading China's foreign exchange reserves to suffer a decline in value and making Beijing cautious about holding dollars.

The direct trading of the yuan and the yen may meet China's desire to minimize risk, as investors view the yen as a safe haven currency during the ongoing global financial crisis.

The MOF official said there are no signs that other nations such as South Korea will follow suit. "To start direct-trading with yuan, sufficient trading based on actual demand as well as financial deregulation are necessary. South Korea may not satisfy those conditions," the official said.

Internationalization of the yuan

For China, this is a step in its moves to internationalize the yuan, accelerating the currency's wider use. More than 9% of China's total trade was settled in yuan last year, up from only 0.7% in 2010, according to Xinhuanet.

Yuan-denominated trade between mainland China and Hong Kong started in July 2009, as Beijing allowed companies in Shanghai and four cities in the southern province of Guangdong to use yuan in trade with Hong Kong, Macau and members of ASEAN. In July 2010, China also allowed the yuan to be more freely traded and transferred in Hong Kong, establishing an offshore yuan market for the first time. Yuan-denominated deposits and financial services are also gaining ground in Japan and the big three Japanese financial groups allow Japanese companies to hold yuan generated through trade as deposits.

But many experts such as Mizuho's Karakama believe China will soon face a trilemma in its economic policy.

An economy cannot combine at the same time a non-floating dollar peg currency, free capital mobility and autonomy in its monetary policy. Developed nations such as Japan and South Korea abandoned a dollar peg system in order to secure international inflows of money and discretionary monetary policies. (By contrast, countries using the euro abandoned individual monetary policy by consolidating their financial policy instruments to the European Central Bank.)

In April, the People's Bank of China announced it would widen the yuan's daily trading limit against the dollar to 1% from 0.5%.

"With the internationalization of the yuan, it will become more and more difficult for China to control the value of the yuan," Karakama said.

Should China shift to a limited floating exchange rate system, the yuan will likely appreciate against major currencies such as the dollar. Japan's business with China expanding and the growing presence of the yuan in Japan's international trade will push down the yen's effective exchange rate against major currencies. Annual trade between China and Japan more than doubled in the past 10 years, reaching $346.6 billion in 2011. In the first four months of 2012, Japanese foreign direct investment in China rose by 16% to $2.7 billion from one year earlier.

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