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China won't suffer from yuan-rouble swap

Did China give money away in the recent yuan-rouble swap? To answer this question, we should first understand that this deal was different from the traditional currency swaps that aim to address liquidity needs in the short term.



In 2013, China's direct investment in Russia exceeded US\$1 billion, 4,500 times the amount of Russia's investment in China.

A case in point is South Korea's currency swap deal with the United States. In September 2008, South Korea was faced with mounting pressures in its foreign exchange market due to the mounting outflow of dollars. To stabilize the market, Seoul signed a US\$30-billion swap deal with Washington in October, and it activated the deal and spent US\$4 billion in the market in November. When order was restored to the market, South Korea paid the principal and interest to the United States at the agreed exchange rate. That's a traditional currency swap.

This is only partially similar to the current situation in Russia. The fall in the rouble was caused by the outflow of dollars, but unless Beijing were to provide Moscow with dollars, the swap wouldn't give Russia any help in the foreign exchange market. Giving yuan to Russia is as useless as giving anti-diarrheal pills to a man with cold.

Actually, the two countries agreed to swap their currencies in order to promote bilateral trade and investment.

Currently, China is working on the internationalization of yuan, but it still has restrictions on capital accounts. Under these conditions, the swap can give Russian companies a chance to acquire offshore yuan and make settlements and investments in yuan.

When China signed the swap deal with Russia, the People's Bank of China, the country's central bank, issued a statement to explain its goal, saying that the deal will facilitate bilateral trade and direct investment and promote the economic development of both countries.

In terms of direct investment, China's investment in Russia is always greater than the other way round. In 2013, China's direct investment in Russia

exceeded US\$1 billion, 4,500 times the amount of Russia's investment in China, which totaled only US\$22 million. This indicates that Russia has been receiving yuan in the investment field, so it has no need to acquire yuan for such purposes via the swap deal.

The trade settlements between China and Russia have been characterized by two major features. First, the majority of the trades were settled in dollars. In 2013, only 6.8 percent of the trades between China and Russia were settled in local currencies. Second, the rouble was used much more than yuan in non-dollar settlements. Around 90 percent of all non-dollar settlements were transacted in roubles, and the currency has remained dominant despite the yuan's rising popularity over the past few years.

Due to these factors, Russian companies are reluctant to settle trades in yuan, and their need for yuan can be simply satisfied by banks' trade financing services. In other words, the rouble will remain dominant in bilateral trade settlements, and Russia has no need to activate the swap deal.

However, with the rouble falling sharply and Russia's interest rate rising substantially, one may wonder whether Russia will activate the deal if local companies change their choice of currency in trade settlements.

It's unlikely that Russian companies will see net expenses in yuan even though the rouble's exchange rate has dropped so sharply. In trade between China and Russia, Russian companies are usually the ones to decide which currency to use. Therefore, when the rouble is devalued, Russian export companies will choose yuan, while Russian import companies will choose the rouble. Under

such circumstances, Russia will see a net income of yuan and will not activate the swap deal.

With Russia raising its key interest rate to 17 percent and its domestic liquidity drying up, Russian companies may have motive to use the yuan as a cheap way of financing. But this is too risky since the exchange rate is fluctuating. Moreover, whether they can use yuan through the swap deal depends on whether the two governments activate the deal.

Even if Russian companies press their government to activate the deal, the deal will also benefit China because it will help promote a steady development of bilateral trade in the midst of the rouble crisis and it will promote the yuan's influence in bilateral trade, challenging the rouble's dominance of bilateral trade settlements.

In a word, China definitely won't suffer from the yuan-rouble swap deal.

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