FOREIGN EXCHANGE

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Renminbi rising?
The move to the status of global reserve currency is by no means guaranteed, writes **Robert Cookson**
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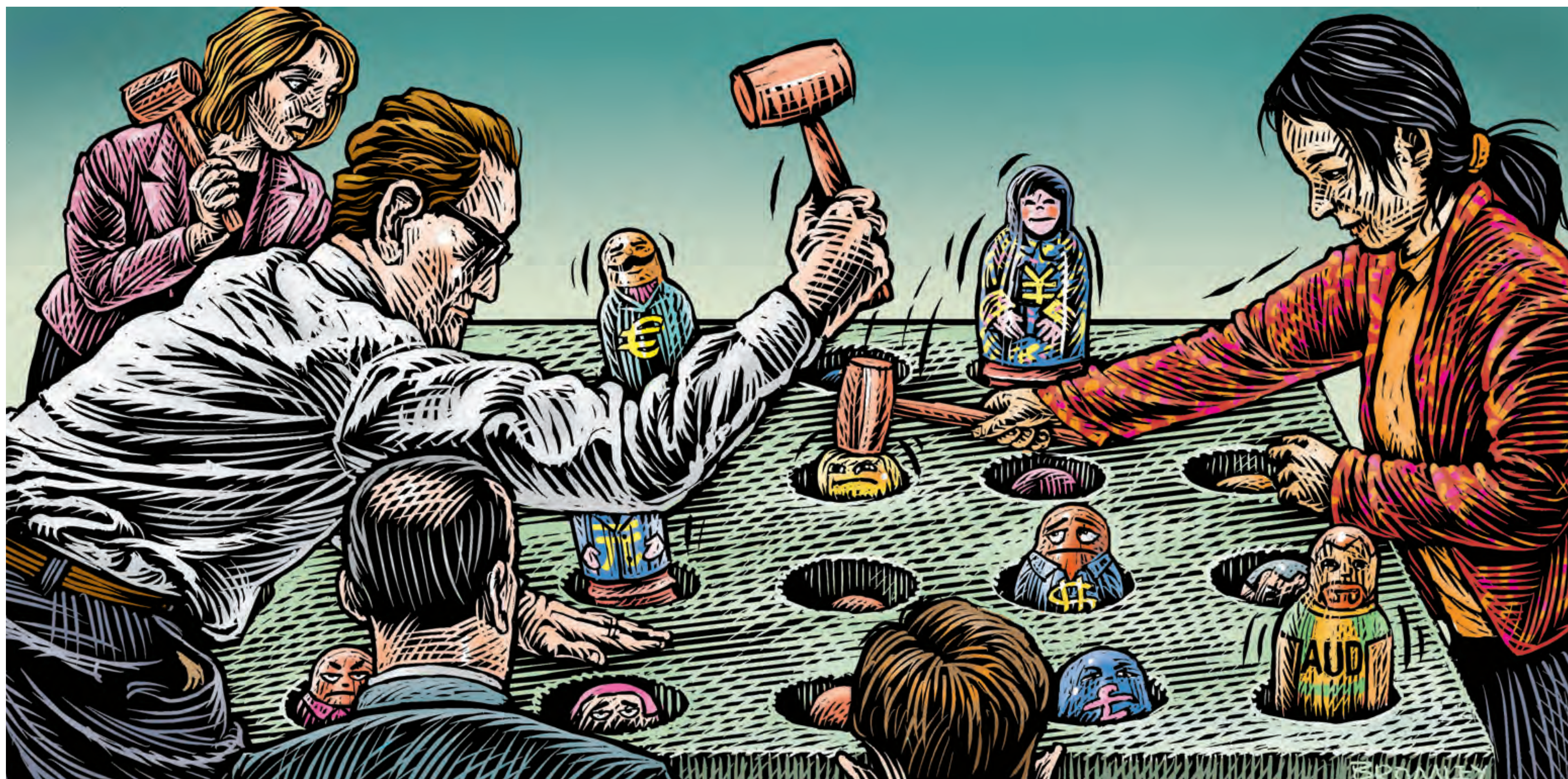

Trading game is less predictable

Alice Ross finds strategists more hopeful after having been wrongfooted by central bank intervention

Foreign exchange traders are hoping 2012 will be a better year. In 2011, many investors and traders found it hard to make money from foreign exchange, as the eurozone crisis dominated markets and central banks unexpectedly intervened to control the value of their currencies.

Traders were particularly hard hit by the euro, which did not fall in value as much as many expected, leading those taking short bets on the currency to lose money.

Troy Rohrbaugh, global head of foreign exchange at JPMorgan, says: "During 2011, many clients came to the market expecting to see a continuing decline in the euro, but that's not how it played out. Some investors spent a lot of money pursuing this view only to be disappointed in the outcome."

Jeff Feig, global head of G10 currencies at Citi, agrees: "For most of our clients, it was a very frustrating year."

This year, however, heads of foreign exchange at investment banks and currency investors are cautiously optimistic that 2012 could see strategies become profitable in the world's largest market, with $4tn traded each day.

Popular ways of making money include the so-called carry trade, where traders borrow in a lower-yielding currency to invest in a higher-yielding one; momentum or trend following, where traders

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Outlook improves for single currency

The euro

Vivianne Rodrigues finds analysts optimistic

Throughout 2011, as the European debt crisis worsened and bond yields spiked in Italy, Spain and even France, a central question was why the euro remained so resilient amid a barrage of bad news.

Granted, the single currency ended 2011 lower against the US dollar for a second consecutive year. It also fell below 100 yen for the first time since 2001, amid frantic speculation about a Greek default and looming recession in the eurozone.

But the declines were not that big – the euro ended the year 3.1 per cent lower against the dollar, 2.8 per cent down against the Swiss franc – when compared with double-digit annual losses in currencies such as the Brazilian real and the Mexican peso.

Now, as the first quarter of 2012 is wrapping up, the euro is once again on the rise. As of March 19, it was up 10 per cent against the yen and 1.5 per cent higher against the US dollar, trading above the $1.315 mark.

The euro is gaining after aggressive efforts by eurozone policy makers to stabilise the European financial system. They have not only orchestrated two bailout programmes for Greece, but also a co-ordinated action among the main central banks to provide cheap emergency funding to the region's banks.

The European Central Bank did it again in February when it offered a second round of cheap loans, with eurozone banks taking €530bn in funds, in a move that helped stabilise markets and pave the way for risk-averse investors to return to region's assets, analysts say.

"I've never seen anything like that," says Scott Boyd, a currency analyst at Oanda, an internet currency trading company. "It was an unprecedented amount of support to prop up the European financial system, with two dedicated bailouts and more recently a big bond swap. All that helped avoid a collapse in the currency."

Mr Boyd says those efforts coincided with long-term selling pressure on the US currency. Local benchmark rates are at record lows and two rounds of additional monetary stimulus by the Federal Reserve have diminished the returns of dollar-denominated assets.

By contrast, at the start of 2011 the ECB had actually increased benchmark rates, which raised returns on euro-denominated assets. The bank later reversed that move.

As the first quarter comes to a close, Greece has just managed to carry out a €206bn bond exchange, diminishing the probability of a disorderly default, and Germany's economy is showing signs that it may be able to avert a recession.

That has been pushing European government bond yields lower, and giving the single currency another respite.

Most analysts believe the threat of an imminent euro break-up has abated, in spite of lingering strains in the financial system and worries over sovereign debt management. Some are even revising their outlook for the single currency to a more bullish stance.

Morgan Stanley said last month that the single currency may trade at $1.34 by the end of the quarter, up from a previous estimate of $1.27. Bank of America has also changed its forecast, and now expects the currency to trade at $1.30 by the end of June, up from $1.25.

Analysts at Citi expect the euro to hit $1.40 by the end of the year, and at HSBC the expectation is for the single currency to trade back at $1.44.

David Bloom, global head of FX strategy at HSBC, says: "On the other side of the euro is the dollar. And as the year progresses and the focus switches back to the US with the presidential elections, people will realise that its debt dynamics are also out of control."

Vassili Serebriakov, a currency strategist at Wells Fargo Bank, says that, while he agrees the outlook for the single currency has improved, he still expects it to trade at $1.24 by the end of the year.

"The ECB policy-easing works twofold: It helps financial markets by lowering the risk premium on various European assets, which in turn helps the euro. But it also expands its balance sheet tremendously at a time when expectations for further Fed easing are diminishing."

The combination of a rebound in the US economy – which triggered this year's rally on Wall Street – and lower market volatility is encouraging investors to take on more risk. That trend may favour higher-yielding assets and growth currencies other than the euro, given the dim economic prospects for the eurozone.

Growth in gross domestic product in the eurozone may slow by 0.4 per cent this year, with countries including Greece and Italy actually falling into recession, according to economist estimates compiled by Bloomberg. In contrast, the US economy is expected to expand by 2.2 per cent.

"The balance is tipping in favour of the dollar," says Chris Walker, a G10 FX strategist at UBS. "Even if you view headline risks as having diminished, the ECB will be expanding its balance sheet, while the likelihood of further easing in the US diminishes with every positive data release."

On the rise: the euro is gaining after aggressive efforts by policymakers to stabilise the system

Private Investors Traders gain from access to information

Foreign exchange trading has long been the preserve of institutional investors but the rise in affordable platforms, coupled with wider access to the information used by sophisticated traders, has made currencies an increasingly appealing asset class for private investors too.

Wealth managers say that clients who previously organised their portfolios along the standard lines of equity, bonds and property are increasingly adding asset classes such as private equity and currencies.

Day-trading platforms and a new range of exchange traded funds have helped the trend by competing on cost to offer retail investors greater opportunities. "Within the past five years, retail forex trading has emerged from the wings to take a much more prominent role on the global currency stage," says Andrei Dirgin, head of research at Forex Club.

Deutsche Bank's retail foreign exchange trading platform, dbFX, uses social media websites to chat to its clients and has uploaded a number of videos on to YouTube offering tutorials. But external forces rather than marketing strategies, have been the real spur, say advisers.

Widespread coverage of the eurozone crisis and the volatility of world currencies have sparked increased interest from investors using investment funds, day-trading strategies via spread betting firms and ETFs to gain exposure.

The top trades picked by retail investors tend to be currencies of large economies that individuals in the US, Europe and UK are familiar with.

More than 85 per cent of all retail transactions involve the US dollar, the Japanese yen, the euro, the UK pound, the Swiss franc and Canadian and Australian dollars, according to the Forex Club.

These currencies tend to be extremely liquid and linked to countries with low inflation and strong central banks. But advisers say that currency trading is still viewed by many private investors as too complex.

Mark Thompson at Global Reach Partners, a foreign-exchange group, has found that the focus of retail investors on currencies that receive the most news coverage does them few favours.

"Rather than looking at the individual merits of a trade from a technical perspective, he says, many private investors base their choices on familiarity with the currency pair.

As a result, they tend to be less successful than their institutional counterparts. "They misunderstand the drivers of FX movement or have the wrong timeframe, or degree of leverage," he says. "Their decision making tends to be event-driven and retail investors as a whole try to pick obvious trades or reversals, rather than jumping on longer-term trends."

Michael Hewson, senior market analyst at CMC Markets, thinks retail investors can be more susceptible to making mistakes when trading than institutional investors, and can end up quickly losing their capital.

""It is extremely important that when they start out, they are educated about some of the pitfalls that are to be found in FX markets," he says.

Spread betting groups offer investors the chance to set in place automated systems to prevent heavy losses, but financial advisers say inexperienced investors interested in overseas currencies may be better off investing in a managed currency fund than taking on the risk of direct trading.

The speed with which currencies can spike means that traders can incur heavy losses in a short space of time. But some platforms say that currencies are easier to trade than equities in many ways. Not only has the internet enabled better distribution of information about the strategies that professional traders use, but price movements tend to be influenced by publicly available macroeconomic data.

Michael Hewson, senior market analyst at CMC Markets, thinks retail investors can be more susceptible to making mistakes

Dean Popplewell, chief currency strategist at Oanda, an internet-based currency trading company, argues that retail investors are certainly not the poorly informed, instinctive traders some believe. "Our last survey showed that 55 per cent of closed retail trades executed on our platform were profitable," he says.

What puts retail investors' profits at risk is the way they react to gains and losses. "It is the risk management of open positions that puts downward pressure on our overall customer profitability number," he says.

"They are far too quick to take relatively small profits, but quite prepared to let losses run and run."

Elaine Moore

Trading game becomes less predictable

Continued from Page 1

buy or sell currencies based on relatively short-term moves in one direction; and value, where a view is taken on the long-term fundamental value of a currency.

All these strategies struggled last year.

High levels of volatility, as traders reacted on a near-daily basis to fresh political headlines from Europe, bedevilled the carry trade, which thrives when volatility is low. Interventions from central banks made it hard to follow trends, as currencies behaved in unexpected ways. The Swiss National Bank's move to weaken the franc in September and the Bank of Japan's intervention to weaken the yen in October led to sudden moves in the markets and caused a number of traders to lose money.

Momentum strategies were also thwarted, as markets veered between risk-on days, when optimism rose and every currency except the dollar was in demand, and risk-off days, when fear levels were high and currencies were sold off indiscriminately.

That risk-on, risk-off trend also made value strategies unprofitable, as currencies were bought or sold regardless of factors such as interest rates or the strength of local economies.

Emerging markets were particularly badly hit, with many of their currencies falling in August and September, as fear gripped the markets, despite longer-term expectations that they will appreciate over time.

The first few months of 2012 have seen new trends emerge, however.

Many believe the dollar is the currency to watch. It has been strengthening in line with better US data. That could lead investors to allocate more money to US assets, allowing the dollar to strengthen.

Such a move would reverse a trading pattern seen last year, whereby the dollar rose when the mood on global growth soured as traders who used the dollar to invest in riskier assets closed their positions.

Mr Feig says: "The surprise here could be a stronger year in terms of US growth and that could change the dynamics in the currency markets, seeing people go long dollars."

Many argue that stronger prospects for the US, along with lower interest rates and the effect of the European Central Bank's longer-term refinancing operations – widely interpreted as a form of quantitative easing – will lead the euro to replace the dollar as the funding currency of choice.

Investment banks already report huge interest from clients to borrow in the single currency to fund investment elsewhere, particularly in higher yielding emerging market currencies such as the Mexican peso and the South African rand.

"The trade that's emerging for 2012 is using the euro as a funding currency," says Zar Amrolia, global head of foreign exchange at Deutsche Bank.

'The trade that's emerging for 2012 is using the euro as a funding currency'

Zar Amrolia, Deutsche Bank

The perceived relative stability of the Swiss franc, with the currency barely moving against the euro at the start of the year after the Swiss central bank set a ceiling for the value of the franc in euro terms, makes it a suitable funding currency for carry trades, market participants believe.

Mike Bagguley, head of foreign exchange at Barclays Capital, says: "One of the big events last year was the euro-franc peg, which makes the Swiss currency an interesting alternative short trade to the euro."

Mr Bagguley says clients have been taking long South African rand versus short franc positions this year, for example.

Currency pairs that have been dormant for months are showing signs of life, providing momentum opportunities. The yen has been on a weakening trend since mid-February, when the Bank of Japan added further liquidity to the system by expanding its bond-buying programme.

Citi says many of its clients profited from trading the dollar against the yen, which had shown little movement since the end of October when the BoJ intervened in the foreign exchange market. Other banks have also seen renewed interest in the dollar yen pair.

For many traders, the yen is replacing the euro as the most interesting currency to try to profit from.

Tim Carrington, head of foreign exchange at RBS, says clients have been spreading their bets among different currency pairs this year. "The investment community has learnt from previous mistakes," he says. "We're not seeing the same crowded positioning we saw last year."

However, while corporates, investors and traders may be finding the currency markets easier, the environment is less positive for market makers.

Volumes were significantly lower in the first few months of the year, as volatility between currencies fell.

Ironically, the relative stability of the euro has been one reason for the drop in volumes, as companies have seen less need to hedge their euro positions while the euro has been trading in a relatively tight range against the dollar.

That could ultimately hurt profits among investment banks, where foreign exchange is regarded as a low-margin but high-volume business.

Some bankers believe this will mean that smaller banks could struggle.

"I think 2012 will demonstrate there's a consolidation going on in the industry," says Mr Amrolia at Deutsche Bank. "In a low volatility environment, the industry will have low volumes and lower profits. I think you will see the larger players increasing their market share."

Greenback likely to remain in the doldrums

US dollar

Traders are waiting for normal service to be resumed, says Jennifer Hughes

It has been extraordinary turn of events.

Hold a mirror to a chart of the S&P 500 and you will see a near-perfect inverse image of the dollar's performance against the euro over the past four years.

The economic theory from which currency forecasting emerged would not have it this way.

Currencies' values should depend on their relative interest rate advantage and, for most developed markets, that means their economic prospects.

Since nothing matters to foreign exchange markets like the dollar – it is one side of nearly 90 per cent of all transactions – this more than justifies the endless fascination of strategists and investors with US economic data.

So when the dollar and the biggest US stock index began to diverge this year, currency watchers were justifiably excited.

Could this be a return to the traditional economics they were brought up on, and a move away from the strange and blunt "risk-on, risk-off" trading that has characterised the crisis-struck years?

The short answer is no. More dovish remarks from Ben Bernanke, the Federal Reserve chairman, last week put paid to that, damping the sell-off in Treasuries and the accompanying rise in market interest rates that had perked up the dollar.

Back to risk-on, risk-off for now, then. In a nutshell, this sees fear-driven days and months in which stocks fall and the dollar gains, as investors seek the safety of the world's deepest financial markets.

More bullish periods involve

> 'Our view is still that QE3 is more likely than not'

stock rallies and dollar falls, as investors seeking better returns leave the US for riskier destinations.

Dealing in the dollar against the euro alone accounts for nearly 30 per cent of the average $1.5bn a day conducted in the "spot" markets, leaving the euro the main beneficiary of the dollar's haven status.

Ironically, this had meant that that, even as the eurozone crisis deepened last spring, still-bullish stock markets had supported the euro trading less than 10 per cent below its record highs – even as the prospect of a eurozone break-up seemed increasingly likely. By January this year, however, worried investors had pushed the euro to a 16-month low against the greenback at $1.267.

At about $1.327 now, the still-intact single currency has recovered comfortably from that nadir, although off a high of $1.345.

The dollar, however, is noticeably stronger than last year. The euro's average daily rate last year was $1.393 but so far in 2012, it has averaged about $1.31.

According to John Normand, head of currency strategy at JPMorgan, the excitement around a potential return to cyclical, interest rate-driven economic analysis was in always way overdone.

"The dollar really hasn't been a pro-cyclical asset in nearly 15 years – at least, not for more than a couple of months at a time – because it has been so low yielding," he says.

"It will be pro-cyclical again when it has high or rising interest rates or a current account surplus, or when it becomes the dominant cross-border mergers and acquisitions target. I don't think any of those are going to happen soon," says Mr Normand.

"For the time being, it is far more likely to continue moving inversely to global growth and stock markets."

Part of the reason for the dollar's sudden rise was also due to the scale of the sudden reversal in expectations.

Talk of better than expected economic growth was a far cry from investors' previous expectations that the Federal Reserve would this year be forced to step in with a further round of quantitative easing, dubbed "QE3".

During a US roadshow of Nomura's macroeconomic views in early February, nearly 80 per cent of investors still expected QE3 during 2012, according to Jens Nordvig, head of fixed income research at the bank.

QE1 and QE2, which essentially allowed the Fed to print money, had been a big factor weighing on the dollar, as investors took the cheap cash and sent it overseas to chase higher returns.

"Our view is still that QE3 is more likely than not, and that the Fed's commitment to hold rates until 2014 is for real, for now," says Ray Attrill, North American head of foreign exchange strategy at BNP Paribas.

"If the market believes that, then the dollar will weaken."

Fortunately for strategists who are measured against their benchmark forecasts, the caution brought on by the extremes of the past four years, with their entirely different trading dynamics and near-constant crisis in the broader economy, had made them cautious in changing their forecasts until the Fed's likely moves weres clearer.

It seems for now, it is.

BoJ Revised policy behind falling currency

The Japanese currency has taken a steep fall against the dollar this year, but few expect this pace of depreciation to continue. In 2010 and 2011, the yen was easily the best performing G10 currency against the US dollar, up 15 per cent and 6 per cent respectively.

So far in 2012, it is easily the worst – down almost 7 per cent against the greenback, compared with rises of between 1.5 per cent and 4 per cent for the rest.

Most currency strategists have called a decisive turn. They note that the catalyst for the yen's fall this year was the Bank of Japan's surprise easing on Valentine's day, amid falling expectations of another round of monetary stimulus in the US. The yield gap between two-year government debt in Japan and the US has more than tripled to 25 basis points, from 7.8 bps at the end of January.

Sophia Drossos, currency fund manager at Morgan Stanley Investment Management in New York, says: "The market's perception that the [Federal Reserve] is less likely to adopt additional quantitative-easing measures has been the great force behind the move in the exchange rate."

The yen, which reached a postwar record high of 75.35 against the dollar last October, has slumped more than 5 per cent since the BoJ expanded its asset-purchasing programme – its main tool of monetary policy with interest rates near zero – while adopting a firmer "goal" of 1 per cent inflation. The yen touched 84.18 in mid-March, an 11-month low.

In a rare commentary on the exchange rate, Masaaki Shirakawa, the BoJ governor, said recently that the revised policy stance was "one factor" behind the falling yen.

Analysts note that the further easing came after the ministry of finance intervened three times in currency markets last year to sell the yen.

Jane Foley, senior foreign-exchange strategist at Rabobank in London, says: "I can't remember so much evidence stacked together from [the government] and the BoJ that they really want the currency to weaken."

More fundamental pressures on the yen remain, says Masafumi Yamamoto of Barclays Capital in Tokyo, such as Japan's enormous government debt burden and the gradual erosion of the country's current-account surplus.

He says that higher oil prices and increased liquefied natural gas imports after the Fukushima nuclear crisis exacerbated the pace of current-account deterioration. In January, Japan reported a current-account deficit more than three times larger than during the 2008 Lehman crisis.

"The fear of twin fiscal and current account deficits, a theme for the US dollar in the 1980s, is now applicable to the yen," says Mr Yamamoto.

In the short term, analysts doubt that this year's rate of depreciation can be sustained. They say the yen remains a counter-cyclical currency, rallying at times of market stress.

If the global backdrop deteriorates and investor risk-aversion resurfaces, the yen could benefit. US yields could also grind lower, as investors flocked to Treasuries, increasing the yen's relative appeal.

Taisuke Tanaka, strategist at Deutsche Bank, wrote in a recent note to clients: "We do not see a US economic recovery and dollar strength against the yen moving steadily in one direction." He says that this time of year has often featured a dollar rebound against the yen.

Further, if the BoJ is unable or unwilling to combat deflationary pressures as vigorously as its public comments might suggest, the yen could resume strengthening.

Those uncertainties explain why, despite its first-quarter plunge, the median forecast of 50 tracked by Bloomberg is for the yen to average 83 to the dollar in the fourth quarter of 2012, little changed from now.

"External events could trigger a lurch back upwards," says Ms Foley of Rabobank. "The yen is still a haven currency."

Ben McLannahan

Masaaki Shirakawa, the BoJ governor

Few signs of fatigue in defence of the real

Brazil

Joseph Leahy reports from the currency war trenches

Guido Mantega, Brazil's finance minister, does not mince his words when it comes to the topic of competitive currency devaluations.

It was Mr Mantega who coined the term "currency war" for the trend, under which countries attempt to gain a trade advantage over each other by lowering their exchange rates. "I consider that a part of the advantage that other countries have over Brazil is due to an artificial exchange rate – without this currency discrepancy, Brazil would be as competitive as them," he says.

To the concern of market analysts and investors, the minister is showing no sign of battle fatigue in a conflict whose weapons are the seemingly mundane tools of international finance – interest rates, monetary policy and exchange rates.

After a surge in the value of Brazil's currency, the real, against the US dollar earlier this year, Latin America's largest economy has renewed its rhetoric, prompting fears of another round of bruising currency controls.

Brazil is not the only one. China has indicated it believes the renminbi has reached fair value against the dollar, threatening to reignite the main theatre in the currency war – Washington's dispute with Beijing over claims the Asian giant is running an undervalued exchange rate. Other emerging markets have stayed relatively quiet, however.

Uncertainty over the economies of Europe and China has eased appreciation pressures on emerging market currencies. "Emerging market growth conditions will continue to look softer than had been hoped for in a cyclical rebound," says Nick Chamie, global head of emerging market research at RBC Capital Markets in Toronto. "We are seeing that coming through, particularly with the disappointment around the Chinese data and that will continue to keep the dollar reasonably well supported."

Guido Mantega, Brazil's finance minister, rails against trend for lowering exchange rates to gain trade advantages Reuters

Brazil spoke of currency war 18 months ago, when a surge of foreign money began driving up the value of the real. International investors were attracted by Brazil's lofty real rates of interest – among the world's highest – and its 7.5 per cent growth rate in 2010.

Mr Mantega blamed the US for not following up quantitative easing by the Federal Reserve with a fiscal stimulus programme to soak up the extra liquidity. Instead, he says, funds were channelled into emerging markets. Brazil responded with a series of controls – a system consisting mainly of taxes on financial transactions – aimed at deterring hot money inflows.

The troubles in Europe in the second half of last year eased the appreciation pressure on the real. But in February, when Europe took measures to shore up liquidity in its banks, Brazil returned to the trenches.

President Dilma Rousseff vowed to do the "possible and the impossible" to ward off what she called an impending "monetary tsunami" from rich countries and the government extended a tax on foreign loans. "I was shocked how fast it took off again," says Benoit Anne, head of emerging markets strategy at Société Générale, of the latest round of hostilities.

But while policy makers continue to talk tough, economists say the real is already looking weaker than last year. It has lost 14 per cent of its value against the dollar from a 12-year high last July and is 5 per cent lower since the intervention in the market in February.

Slower growth in emerging markets and Europe points to an easing in commodity price inflation, taking some momentum from the real, economists say.

The government also seems to have had some success in scaring investors who lack the same conviction about a strong real that they had in September 2010, when the currency war began.

The government has sought this time to intervene as soon as the real strengthens to about R$1.70 to the dollar, while ensuring it does not depreciate much past R$1.90. This range is nominally weaker than in September 2010, when the government was seeking to devalue the real whenever it approached R$1.65-R$1.60.

But in effective exchange rate terms, R$1.70 today is in fact a stronger level than the government was tolerating 18 months ago.

Analysts say that, unless growth picks up markedly, investors will be channelling funds to emerging markets with less intensity. Yields on local bonds in these markets are lower than they were during the first round of the currency war, interest rates have fallen and there are hopes that stocks will pick up.

The global economy could yet hold some wild cards. After slowing sharply in the second half of 2011, Brazil is showing signs of recovery. If it heats up more rapidly than expected and grows at close to 4 per cent this year, capital could again start to flow into the market in sufficient quantities to force the government to take action on the exchange rate.

China could be another unpredictable factor. Any sharp weakening of the renminbi would put pressure on other emerging market currencies. But analysts do not expect aggressive action from the People's Bank of China on this front.

"With China it's not usually the blitzkrieg, more like the 100 years war," says Mr Anne.

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Achieving more together

Renminbi centre: the UK Treasury wants to make London the leading international centre for trade in the Chinese currency

Renminbi not yet ready to challenge the dollar

Reserve currencies

Beijing has a long way to go, says **Robert Cookson**

It has become conventional wisdom among many prominent economists, bankers, and politicians that the Chinese currency is on a path that will inevitably make it a global reserve currency to rival the US dollar.

So great is the excitement around the future international role of the renminbi that George Osborne, UK chancellor, in January launched an initiative to help London become a global hub for renminbi foreign exchange trading.

Writing in the Financial Times last September, Arvind Subramanian, a senior fellow at the Peterson Institute for International Economics – in an article titled "Coming soon: when the renminbi rules the world" – declared: "internationalising the renminbi has been set in irreversible motion".

However, contrary to popular perception, the renminbi's rise is by no means guaranteed and could take decades, if it happens at all.

China is certainly big, representing about 10 per cent of global gross domestic product, and growing fast. It will overtake the US as the world's biggest economy by 2027, according to estimates by Jim O'Neill of Goldman Sachs. But China's size does not mean its currency is about to challenge the dollar or the euro – or even the yen or the pound – any time soon.

For the renminbi to become a reserve currency, one that is held by central banks as part of their foreign exchange reserves to guard against balance of payments crises, Beijing will need to implement sweeping reforms.

At present, China retains strict controls on its capital account. Under current regulations, people and companies can only move renminbi in and out of the Chinese mainland through a limited number of channels, such as trade deals, and investments that have been approved by the state.

By retaining these restrictions, the Communist Party is able to exert control over key aspects of the Chinese economy, including the exchange rate, interest rates, and the allocation of capital through the state-owned banking system.

Eswar Prasad and Lei Ye wrote in a recent report for the Brookings Institution: "The renminbi is unlikely to become a prominent reserve currency – let alone challenge the dollar's dominance – unless it can be freely converted and China adopts an open capital account."

The question is whether Beijing's unelected policy makers have the political will to dismantle China's capital controls, given that doing so would remove much of their power over the domestic economy.

While Beijing has removed restrictions on some types of cross-border flows of the renminbi in recent years, the currency is still a long way from being fully convertible. There is no doubt reforms can have big effects. Chinese companies now settle about 10 per cent of their international trade deals using the renminbi, just two years after they were permitted to do so by mainland authorities.

But investment flows are still small because China's financial markets are still nascent and foreigners have only limited access. In March, China gave Japan permission to buy up to Rmb65bn ($10bn) of Chinese government bonds, a sum that amounts to less than 1 per cent of Japan's foreign exchange reserves, which are mainly held in US dollars.

> You can only move renminbi in and out of the Chinese mainland through a limited number of channels

If central banks are to hold the renminbi as a significant part of their reserves, they will need much greater access to Chinese assets. And for the renminbi to challenge the dollar, China's financial markets would need to become as broad, deep, and liquid as those of the US, a process that would require both time and substantial reforms.

Even after sweeping reforms, however, the renminbi's ascendance would not be guaranteed.

Consider Japan, an economy almost exactly the same size as China. Unlike its neighbour, Japan has both an open capital account and deep and liquid financial markets. Back in the 1980s, the Japanese government made it a stated policy to "internationalise the yen", and many observers expected the currency to challenge the dollar as a reserve currency.

Over the past four decades the Japanese yen has taken on a bigger role in global financial markets. Nonetheless, compared with currencies of other developed countries, its international usage and acceptance is "rather low", says Dickson Ho, an economist at the Hong Kong Trade Development Council.

Only about 40 per cent of Japan's exports and 20 per cent of imports are settled in yen. The yen now accounts for less than 4 per cent of official global foreign exchange reserves, according to the International Monetary Fund, down from a peak of 8.5 per cent in 1991.

By contrast, the US dollar and the euro account for about 62 per cent and 26 per cent of global reserves respectively.

If Japan's experience is any guide, it shows China has scope to expand global use of the renminbi for trade and investment.

Challenging the dollar as a global reserve currency, however, is another matter.

Local currency bonds A rocky ride

For much of last year, local currency-denominated emerging market bonds were one of the hottest asset classes, as investors sought to benefit from high yields and the strengthening currencies of robust developing economies.

This investment thesis held up well during last summer's turmoil, but by autumn many emerging market currencies were in free-fall, hammering the overall returns of local currency bonds. This stark reminder of the risks of locally denominated assets has soured some investors.

Christian Keller, a senior emerging market strategist at Barclays Capital, says: "We've seen fund flows return to emerging markets, but mostly focused on hard-currency funds. Investors are still cautious about local currency bonds."

The currency side is integral to the returns of local emerging market bonds. Bhanu Baweja, head of emerging market fixed income and currency strategy at UBS, estimates that during the past 10 years, the currency component has contributed on average 46 per cent of total returns in the seven years when currency and bond components have both been positive.

But in the two years when the total return was negative, the currency component contributed 300-400 per cent of the loss. Only once in the past decade, in 2004, has the total return for local emerging market bonds been positive despite the currencies sliding, says Mr Baweja.

Many remain convinced, however, that aside from the odd bout of volatility, the vast majority of these emerging market currencies is set to strengthen markedly against developed ones in the long term.

Bryan Carter, a fund manager at Acadian Asset Management, says: "We believe that emerging market currencies will appreciate in the long run, as their countries grow faster than developed countries in per capita terms."

Indeed, 21 of the 25 largest, most liquid emerging market currencies have rallied against the US dollar this year, led by the Hungarian forint, the Polish zloty, Mexico's peso and Russia's rouble.

Some strategists argue that the rouble market in particular has more room to rally, given the outlook for oil prices, and the appetite for Russia's nascent offshore rouble-denominated "OFZ" market for government bonds.

Several global banks are beefing up their local currency debt issuance capability, as they expect the asset class to continue to gain in prominence.

The more muted investor interest this year "is more of a pause than an expression of bearishness", says Chris Jones, global head of local currency debt syndicate at HSBC.

Mr Keller agrees the investment case is broadly intact. "Local currency bond fund flows stabilised quite quickly after the pullback, and there is a strong underlying shift under way," he says. "International institutions are likely to increase their allocations."

Indeed, some investors say local currency emerging market debt will not remain the preserve of smaller, specialist asset managers for much longer. "Emerging markets countries have better fundamentals than developed countries," Mr Carter says.

Some investors argue, however, that the volatility – and illiquidity in some local bond markets – mean the returns aren't always commensurate with the risks.

Tony Adams, co-head of global credit at First State Investments, says: "Talk of the death of the US dollar has been premature, and people realise emerging market currencies are not a one-way train."

Chris Iggo, chief investment officer for fixed income at Axa Investment Management, also favours hard currency emerging market bonds over those denominated in local currency. "People underestimate the illiquidity and volatility. If you can handle these the returns can be good, but it's a rocky ride."

Polina Kurdyavko, a portfolio manager at BlueBay, a London-based asset manager estimates the volatility of local currency corporate debt is more than double that for "hard" currencies such as the dollar and euro, and that the liquidity is 10 times worse. "Given this, the returns aren't always that attractive," she says.

Robin Wigglesworth

Christian Keller, a senior strategist at Barclays Capital

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Foreign Exchange

Strains ease as Swiss stick to ceiling

Intervention

Weaker franc has reduced volatility in forex markets, says **Haig Simonian**

Dates are seldom commemorated in the rough-and-tumble foreign exchange markets, let alone celebrated. But for the Swiss National Bank, March 6 2012 was a day to remember.

That marked six months since the central bank's imposition of a SFr1.20 ceiling for the franc against the euro – an unconventional step taken after more timid measures had failed to arrest what seemed to be a one-way upward move for the Swiss currency.

The SNB's unprecedented action, backed by threats to enforce its minimum level "with the utmost determination", including buying foreign currencies "in unlimited quantities", capped months of tension during which the franc kept rising.

The franc's trajectory had been boosted by investors' fears of a eurozone meltdown amid spiralling national debts and ever shakier bank balance sheets. In the US, confidence was plunging as political paralysis in Washington failed to address profound economic and fiscal imbalances.

To cap it all, the SNB had earlier thrown in the towel after attempts to arrest the franc by direct intervention had lumbered the bank with billions of euros and dollars whose value was depreciating fast as the franc climbed. By August, the Swiss currency briefly touched parity against the euro, while the dollar sank to almost SFr0.70.

Against many forex strategists' expectations, the SNB's ceiling has held. Moreover, based on data available, it has cost less than expected. More impressive still, much of this has happened during a rare internal crisis, with the resignation in January of Philipp Hildebrand as SNB chairman and the continuing failure of the government to appoint a permanent successor.

The SNB has held its position, mainly because traders respect the bank's determination and accept it could print money to finance endless intervention. While that ought to stoke inflation, it has been falling rather than climbing prices that have been the SNB's concern.

Paul Robinson, head of forex research at Barclays Capital, says: "The single most important factor has been the SNB's strong, unambiguous language. That worked very well indeed. The bank has put its credibility at stake."

The SNB's achievement has come in spite of the fact that Thomas Jordan, previously vice-chairman and now interim chairman, has yet to be confirmed permanently in the post. And the franc's ceiling has withstood the huge strains in the eurozone.

The SNB's financial results have demonstrated its success. Last month, it reported a SFr13.5bn net profit for 2011, compared with a SFr19.2bn loss in 2010. Earnings, as in previous years, were bolstered by valuation gains on bullion but, in contrast to 2010, the SNB also recorded a positive return on its foreign exchange reserves.

That may have been inevitable, given the successful imposition of the ceiling and the apparently limited need for enforcement. The SNB's foreign currency holdings rose in value in Swiss franc terms as the franc depreciated – prompting friendly jibes of "insider trading", given the SNB's foreknowledge of its intervention and that it benefited significantly from its impact.

Where does Switzerland go from here? Price data suggest the deflationary pressures officials cited as their motive for setting the ceiling have diminished.

Producer and import prices fell 1.9 per cent in February year-on-year, but rose 0.8 per cent month-on-month. For import prices, the February increase continued a trend that began last December, when month-on-month changes turned positive for the first time after six months of decline. Consumer prices have also turned positive, with February showing the first monthly gain in five months.

The ceiling has eased Swiss exporters' and economists' fears of a collapse in foreign sales and recession – concerns that appear exaggerated now. In its latest monetary policy assessment, the SNB acknowledged that "the minimum exchange rate is having an impact".

But many politicians have called on the bank to weaken the franc further. Trade unionists and leftwingers have suggested SFr1.40 as a more appropriate ceiling.

The SNB agrees the franc is still high, but opinion is divided on how to proceed.

Broader macroeconomic factors appear to be going Switzerland's way: exports have been more robust than expected, while the eurozone crisis has eased. And, having successfully enforced SFr1.20 without provoking a speculative onslaught, the SNB may be wary of pushing its luck.

"The minimum level has reduced exchange rate volatility and given business leaders a better basis for planning," said the latest assessment.

But some believe further action will come. Mr Robinson at Barclays predicts: "Barring unexpected problems in the eurozone, SFr1.25 is likely, and SFr1.30 is even possible in the longer term."

Philipp Hildebrand, former president of Swiss National Bank

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