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Currency Agreement for Japan and China

By EDWARD WONG and NATASHA SINGER

BEIJING — China and Japan have agreed to start direct trading of their currencies, officials announced during a visit here on Monday by Japan's prime minister, Yoshihiko Noda.

Japan will also apply to buy Chinese bonds next year, allowing it to accumulate more renminbi in its foreign-exchange reserves. The moves were among several that emerged from Mr. Noda's meetings with President Hu Jintao, which focused on how the two nations could work together to maintain peace on the Korean peninsula.

China is the world's second-largest economy while Japan is the third largest, and the currency agreement is part of a move away from using dollars. Chinese officials have said recently they would like to broaden the global use of the renminbi, also known as the yuan, and want to see more countries move away from relying on dollars as the worldwide currency.

They hold the world's largest foreign-currency reserves — China has about $3.2 trillion, while Japan holds $1.3 trillion — and any moves to reconstitute the makeup of those holdings could change the global currency map.

"Chinese officials have made it clear that they believe the international economy is too heavily dominated by the dollar," said Charles A. Kupchan, a professor of international affairs at Georgetown University and a senior fellow at the Council on Foreign Relations. "They believe, as part of China's rise, that the international system should move to a more balanced structure."

Because the renminbi is not fully convertible, however, it will not compete soon as a global reserve currency, he said. Still, the agreement "could be a baby step in that direction," Professor Kupchan said. Experts in global trade said China and Japan had both practical and political motives for the pact. Neither side has announced a timetable, agreeing only that officials will discuss possible measures.

Given the proximity of China and Japan, along with the likelihood that the two countries will serve as each other's biggest trading partners over the next century, it makes sense for them to trade directly without using dollars, said Jeffrey H. Bergstrand, a professor of finance at Mendoza College of Business at the University of Notre Dame.

And the more China loosens its grip on the renminbi, helping to correct what by some measures is a currency undervalued by almost 40 percent against the dollar and 45 percent against the yen, the greater its purchasing power will become, allowing it to import more. This is especially important for Japan, which has been reeling as the dollar has weakened, making American consumers unable to spend as much on Japanese electronics and cars as they used to.

From a practical standpoint, both China and Japan want to reduce the transaction costs of direct bilateral trade and the risks of volatility in exchange rates, said Professor Kupchan.

“With markets looking askance at both the euro and the U.S. dollar, investors in both China and Japan would find it attractive to trade directly,” Professor Kupchan said. On a more political level, he said, the pact also represents an important step in improving bilateral ties between Beijing and Tokyo.

As for the long-term ramifications for the United States, analysts said it was difficult to predict before the pact took effect.

In the shorter term, the agreement is likely to lead to continued weakening of the dollar against the renminbi, Professor Bergstrand said. That should help the United States trade deficit with China, he said, increasing American imports while weakening imports from China. On the other hand, he said, the Sino-Japanese currency agreement is likely to diminish the dominance of the dollar in global trade.

“The Chinese yuan will increasingly play an important role in Asia,” he said. “It does mean that the U.S. dollar will be less important as a currency for transactions in Pacific rim trade.”

Professor Bergstrand compared the role of the dollar on the world stage now to the waning of the British pound 100 years ago as the most prominent currency for international transactions.

For more than a decade, critics have said the government has kept the value of its currency artificially low, giving Chinese exporters an unfair advantage over American counterparts by making Chinese goods cheaper overseas. Washington has pushed for a revaluation. Beginning in June 2010, facing increased inflation, China began to let its currency float gradually up.

Professor Kupchan of Georgetown said the currency pact is more symbolic than significant right now for the United States. “This pact hardly unseats the dollar as the world’s dominant currency,” he said. “But it is a clear sign that China is headed in the direction of internationalizing the renminbi.”

Edward Wong reported from Beijing and Natasha Singer from New York. Hiroko Tabuchi contributed reporting from Tokyo.