BLOG

Analysis: Will Chinese renminbi be included in the IMF currency basket?

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The IMF reviews every five years its currency basket, the so-called SDR (Special Drawing Right). Each time the selection criteria, the selection of currencies, the weighting methodology and the composition of the SDR interest rate basket are assessed. This year the review will take place in November. In the upcoming review, the main discussions will focus on the possible inclusion of the Chinese renminbi (RMB) into the SDR-basket and more specifically, if the RMB can be defined as a "freely usable" currency i.e. whether it is widely used and widely traded.

In the assessment the operational implications and the potential costs of the inclusion will be weighed against the benefits. While the decision will rely on an extensive technical analysis, it will ultimately be based on the judgement of the IMF Board where all the member countries are represented. Politics will also play a role, as China has been very actively lobbying for the inclusion of the RMB and systematically conducting significant reforms in order to meet the requirements. The Managing Director of the IMF has stated that RMB inclusion is not a matter of 'if' but 'when'.

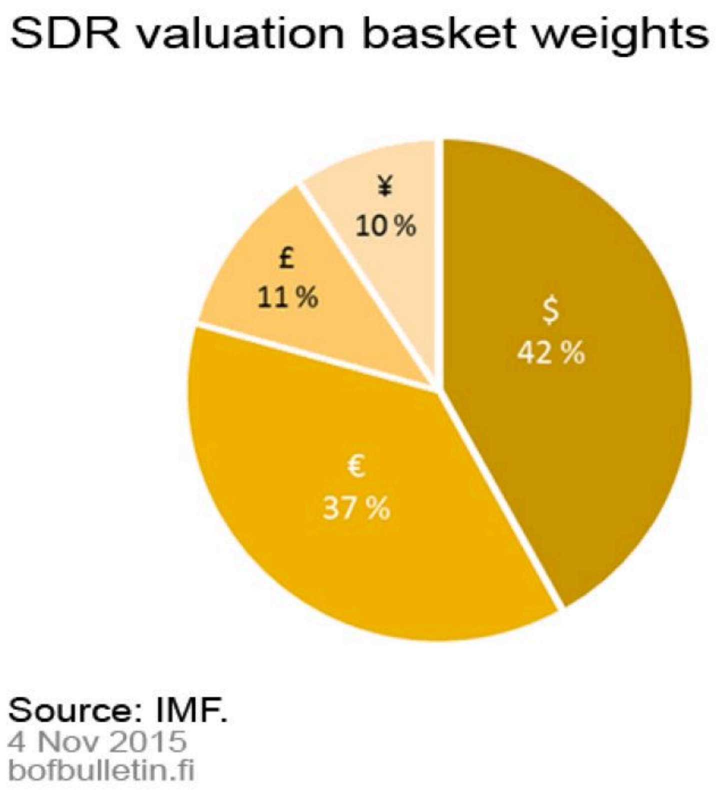
What is the Special Drawing Right?

The SDR was created in 1969 by the IMF as an international reserve asset. The purpose of the SDR is to supplement international reserves, be a form of unconditional international liquidity and serve as a unit of account for IMF operations. There are about $280 billion worth of SDR's created and allocated to 188 IMF members (March 2015). Initially the value of the SDR was tied to gold, but after the Bretton Woods system collapsed a basket approach for the valuation was adopted.

Originally, the basket included 16 currencies, i.e. the currencies of the countries whose share of the world exports was over one percent. This composition was found challenging to manage and in

1980 the number of currencies in the SDR basket was reduced to five (USD, DEM, FRF, GPB and JPY). In 2000 the DEM and the FRF were replaced by the euro. Currently the USD and the euro carry the largest weights of 42 percent and 37 percent respectively, compared to 11 percent weight of the pound and 9 percent of the yen.

Chart 1.



Method of valuation

The review of the SDR basket is guided by a set of principles and the defined method of valuation.[1] The method of valuation can be determined by a 70 percent majority of the Board voting power, while a change in the principle of valuation or a fundamental change in the application of the principle in effect would require an 85 percent majority.

The current method was adopted by the Board in 2000. It has three key elements. Firstly, the currencies selected should be the four largest currencies that are issued by the largest exporters and they should be defined as freely usable. Secondly, currency weights are based on the currency's relative shares of official foreign exchange reserves and exports. Thirdly, the reviews of the valuation method are conducted every five years.

In addition, a set of broad principles guide the method. These principles require i) the SDR value to be stable in terms of major currencies, ii) the SDR currencies to be representative in international transactions, iii) the weights in the basket to reflect the currencies' relative importance in the world trade and financial system, iv) the composition of the SDR basket to be stable and v) continuity to be maintained in the method of valuation.

For example, accepting the addition of the RMB as a fifth currency into the SDR basket would need a 70 percent Board majority as it would require a change in the method of valuation (from four largest currencies to five), but still be in line with the principles that guide the method of valuation. In the initial discussion of the review in July, the Board decided to extend the current basket from December 31, 2015 to September 30, 2016 for operational reasons and to allow enough time for adjustment if the RMB was to be included in the basket. However, it was made clear that granting the extension does not prejudge the outcome of the November review.

Free usability is critical for the IMF

China is the third largest exporter in the world fulfilling the so called "gateway criterion" of having a sufficiently large share of global exports. It is also the only non-SDR currency to do so. Therefore the focus in the upcoming review will be on whether the RMB fills the free usability criterion.[2]

Free usability plays a critical role in IMF operations. It ensures that currencies received from Fund programs can be directly used for balance of payment needs. Members whose currency is not defined as freely usable have a legal obligation to exchange their currency into a freely usable currency for Fund operations. A freely usable currency should fulfil the criteria of being widely used to make international payments and widely traded in the foreign exchange markets.[3] There are a set of quantitative indicators that can be used to assess if a currency is widely used and traded to support the decision on whether a currency is freely usable. It should be noted that neither full capital account convertibility nor a floating exchange rate is a prerequisite for inclusion in the SDR basket. Ultimately the decision is based on the judgement of the Board. By defining RMB as freely usable, it will qualify for IMF payments. For example, a country borrowing from the IMF could receive its loan tranche in RMB.

Alternative SDR-valuation criteria were reviewed by the Board in 2011. It was concluded that the freely usable criterion remains valid for a SDR-basket currency. The Board also agreed that when considering whether a currency is widely used, important indicators are: share in official reserve holdings; share in international banking liabilities; and share in international debt securities. Similarly, the volume of transactions (turnover) in FX markets should be used when assessing if a currency is widely traded. In the July discussion also additional indicators were suggested to be added to the analysis.[4]

The international role of the RMB

The IMF staff has concluded that, most of the indicators used to asses free usability rank RMB behind the four currently freely usable SDR-currencies, but generally the highest of the non-freely usable currencies. These indicators have however been criticized of being static and understating the increasing role of the RMB both as a reserve currency and as a currency used for international trade and financial transactions. Data and measurement issues are another challenge for the assessment. Since the last review, there has been a very rapid increase in the use of RMB for payments, investments and reserves.

China has proven its commitment to support the internationalization of the RMB by implementing a large range of reforms and liberalization measures. In the domestic financial markets, the authorities liberalized interest rates for bank loans in 2013 and increased the freedom to set deposit rates. The deposit insurance system was introduced in May 2015. Along with these changes, restrictions on capital movements have increasingly been lifted to allow RMB to flow more freely in and out of China. This summer, for example, central banks and other institutional investors got full access to China's large domestic interbank markets. In August, the People's Bank of China (PBC) changed the mechanism of how the RMB's exchange rate is determined to better take into account the true market situation. While the impact of this move is still to be seen, it demonstrates the commitment of the key decision makers to make the exchange rate more flexible and to continue the internationalization of the RMB. At this point, it is interesting to note that the IMF sees the changes in the exchange rate mechanism as a welcome move to allow a greater role for the market forces to work. The Fund has also stated that they do not view the RMB as undervalued.

The rise of the RMB in the international arena is a natural result of the large size and dynamism of China's economy. It is also an outcome of strong support by the Chinese authorities as the RMB plays an important role in China's strategy for increasing the role of the country in the world. This support is demonstrated, for example, by the fast development of the market infrastructure to promote the use of the RMB (clearing banks, China International Payment System). In addition to the above, the Chinese central bank has established swap arrangements with a number of other central banks, both in Asia and elsewhere. Given the combination of the market forces and strategic backing by Chinese policy makers, only major disruptions in China or elsewhere could derail the process of RMB's rise. However, despite the large reform efforts of the Chinese authorities, a number of reforms still need to be completed and successfully implemented especially for the RMB to meet the operational requirements of a freely usable currency

Operational implications of RMB entry into the SDR basket

Several operational challenges arise from the possible RMB inclusion into the SDR-basket. The most critical are i) how to define a representative exchange rate for RMB against the USD for SDR valuation purposes, ii) are there enough instruments to allow hedging the risk related to the RBM share of the SDR and iii) is there a suitable interest rate instrument for the SDR interest rate basket. Overcoming these challenges will be essential to ensure smooth functioning of IMF operations and smooth usability of the SDR.

China has been taking steps to allow for better access to the CNY onshore market and continuing the gradual opening of the capital account. Fully implementing these reforms will be important for the Board to be able to judge the RMB as freely usable. Overcoming the operational challenges will be particularly important for central banks who will bear the largest share of the potential costs arising from issues such as having limited possibilities of hedging their RMB positions and thin FX markets to conduct RMB transactions. It is also worth noting, that the potential additional operational costs may be even higher to the central banks who are participants of the IMF voluntary trading arrangements and therefore may have a larger amount of transactions to conduct.

SDR exchange rate valuation

A daily value of SDR against the USD is calculated by summing up the market exchange rates of SDR-currencies against the USD. According to the current practice, a suitable exchange rate for RMB/USD should be available in London (BoE) and New York (Fed) as well as in Frankfurt (ECB). Staff has positive indications from BoE, that this rate could be made available, but no information from the Fed nor the ECB.[5]

In addition, a market-based "representative" RMB FX rate in terms of the USD would allow to calculate the value of RMB against the SDR. The IMF staff has identified a potential benchmark exchange rate calculated daily by the China Foreign Exchange System, which could be suitable. This is an onshore rate and as IMF transactions would be based on this rate, Fund members would need to have access to the onshore market. Removing capital controls and other restrictions will allow further convergence of the onshore and offshore rates.

SDR interest rate

The SDR- interest rate is used for example to calculate the interest for Fund operations and the interest paid to the countries with a creditor position in the IMF. If a new currency were added to the SDR basket, it is assumed that an instrument in that currency would be added also to the interest rate basket. In previous Board discussions it has been noted that the availability of such an instrument can also be seen as one indication of free usability. The Board has defined a set of criteria which the interest rate instrument should fulfil.[6]

In the staff has suggested that a three-month sovereign yield, published daily by the China Central Depository and Clearing Company, could be considered as a suitable interest rate instrument.[7] This rate could possibly qualify after the implementation of the measures that China has committed to in developing the market and increasing access to the onshore bond markets. Further analysis will be conducted by the staff to ensure that the operational requirements of the interest rate instrument are fulfilled.

As the interest rates in China are higher, adding a RMB interest rate instrument to the SDR interest rate basket is likely to lead to a structural increase of the SDR-rate. This would increase the interest paid to creditor members and the interest paid by the programme countries, including low income countries.

Possibilities to hedge

Being able to hedge the SDR-positions with reasonable precision and costs is important for both borrowing and creditor members as well as for IMF Investment Account and Trust management. This would require suitable hedging instruments for the RMB. These are increasingly becoming available, but capital controls and restrictions still hinder the ability to access onshore markets. The PBC has announced a set of reforms opening up the capital account and alleviating restrictions. The effects of these measures and their implications on the hedging opportunities will be further analysed in the November review.

Weights of the SDR basket

The currency weight should reflect the relative importance of the currency in the world trade and finance. The weights given in the 2010 review were about 67 percent for exports and 33 percent for reserves. This method has been in place since 1978 and has some shortcomings, such as not being reflective enough of the large increase in private international financial flows. Staff will develop a new weighting method proposal for the November review.

Currently the weights of the SDR-basket currencies are defined by adding the issuer countries exports and the amount of currency held in other countries reserves. Calculating RMB's weight in the possible basket will not be straightforward due to poor data availability on the RMB reserves.

IMF staff estimate a share of 14-15 percent using the current method, depending on the amount of currencies in the basket (four or five).

While meeting the free usability criterion does not require a floating exchange rate, co-movement between two SDR currencies can be expected to increase the volatility of the SDR. There has been a relatively high degree of co-movement between the RMB and USD, which has been somewhat reduced by China's recent moves to increase the flexibility of RMB exchange rate. The risk of increasing volatility could be mitigated by adjusting the weights of the co-moving currencies in the basket. It will be important to ensure that the possible addition of the RMB into the SDR-basket does not increase its volatility. When proposing a new weighting method, staff may present a formula that poses a rather low weight to the RMB at least at the initial stage SDR basket inclusion.

Would adding the RMB into the SDR basket affect the credibility of the SDR?

Maintaining the credibility and usability of the SDR is a principal objective of the review. This will require that any SDR-basket currency is freely usable and fulfils the operational requirements. Resolving the issues related to data and adding the information from the new indicators should provide more proof that the RMB is "widely used and traded" for a supportive decision in November. The reforms to meet the operational criteria will also need to be implemented by the review. In addition, the Board should be confident that the reform efforts in China continue and are not reversed. For reserve managers who will have to begin to trade in RMB instruments, it is crucial that the markets function smoothly after the reforms. Ideally, they should have operated smoothly for a while before the RMB is taken on board. Adding a new currency will also set the bar for potential other currencies to be added at a later stage. Stretching the criteria now, will possibly lead to pressure to do it again later, which could undermine the credibility of the SDR.

On the other hand, not recognizing the fast growth in the role of the RMB may further increase the tensions between the advanced economies and the EMEs stemming from the stagnation of the IMF governance reforms. This could well lead into China increasing its global role by focussing even more on regional and bilateral arrangements, which could undermine the credibility of the SDR and the whole multilateral system.

Strengthening the international role of the RMB is a strategic objective of China. China has systematically and with growing speed progressed with the liberalization of the financial sector. Ultimately, the rise of the RMB is a direct consequence of China's membership in the WTO in 2001 and the subsequent successful integration of China into the world economy. From this perspective, one could expect China to pursue this path and be as committed to the requirements for inclusion in the SDR as it has been to its WTO commitments. But such commitment should nevertheless not be taken for granted.

Moving towards a financial and monetary system guided by market forces will be an important step towards being included in the SDR-basket. The on-going turbulence in the Chinese markets is a good reminder of the related risks. However, it can also be seen as an indication of a more market based economy adjusting to internal imbalances. China's policy reactions following the turbulence will be an important signal on the degree of the government's commitment to reforming the financial sector.The evidence so far indicates that the market turbulence has not derailed the reform progress in China. However, if policy reversals are seen, they may support postponing the possible inclusion of the RMB to SDR basket to a further date. With a 70 percent majority, the Board could decide to conduct another review when they see that one is needed.

Key words

China, IMF, SDR