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China Claims Top Currency Status

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OVERVIEW

Bottom Line: China's request to include its currency, the renminbi (RMB), in an International Monetary Fund (IMF) currency basket is political as much as economic in intent and effect. The IMF is likely to decide late this year to include the RMB in the basket, known as the special drawing right (SDR), but the path to "yes" poses challenges to the IMF and the U.S. government and needs to be carefully managed.

Every five years, the IMF updates the currency basket it uses to denominate its transactions. The SDR is used primarily in IMF operations, as well as in a small number of private and public transactions. Usually, these reviews are dry, technical affairs. This time is different, following the March 2015 request from the Chinese government to add the RMB to the basket. If agreed, the introduction of the RMB in the SDR represents a significant milestone in China's transition to a less-regulated economy, and a further effort at global economic leadership following the launch of the Asian Infrastructure Investment Bank (AIIB) earlier this year.

> *RMB's inclusion in the SDR would signal a milestone in China's transition to a less-regulated economy.*

The Chinese request has drawn statements of support from a broad range of industrial and developing countries. The Obama administration's position has been muted, signaling support for reforms that would make the RMB a truly international currency without stating whether there has been sufficient progress to justify U.S. support. The IMF analysis is unlikely to make a compelling case in either direction, presenting a range of indicators suggesting a mixed picture. The IMF staff recommended transitioning to the new basket in September 2016, nine months later than usual. This extended transition does not prejudge the decision on the RMB, but it would make it easier for markets to adjust to a new basket. A separate IMF board meeting later this year will be necessary to decide on the composition of the new SDR.

Earlier this week, the IMF released a paper outlining the process of the review.

SDR ALGEBRA

IMF loans are denominated in SDRs, but in practice countries can ask for, or pay, in any of the currencies in the basket when transacting with the IMF. Borrowers do bear the exchange risk of the basket denominated in SDRs, but they can hedge it, and there is increasing evidence that sovereign asset managers actively hedge such exposures. The SDR basket currently contains four currencies—the U.S. dollar, the euro, the Japanese yen, and the U.K. pound. Initially sixteen currencies, the SDR was reduced to five currencies in 1980 and to its current composition in 2000, after the introduction of the euro. The number of currencies in the basket has never been increased.

The IMF has a two-tier test for inclusion in the SDR. The first test—a gateway for consideration as an SDR currency—aims to limit the basket to currencies that provide for stability in terms of the major currencies and that are "representative of those used in international transactions." In practice, this means that the country needs to be a major trader, measured primarily by exports, without an excessively volatile currency. China was seen as meeting that test in 2010, and, as one of the world's largest economies and exporters is certain to meet this test again in 2015.

The second test, introduced in 1977 after the advent of the floating rate system, mandates that the currency be "freely useable," meaning that it is "widely used to make payments for international transactions" and "is widely traded in the principal exchange markets," as defined by IMF's Articles of Agreement XXX(f) The interpretation of these criteria has evolved over time with innovation and the deepening of international capital markets, and is assessed by looking at a range of indicators. These include trade and trade credit, capital flows, forward markets, and the spread between buying and selling quotations for cross-border transactions denominated in that currency. The foreign exchange market for the currency needs to be deep and broad, so that, at a minimum, governments are able to buy and sell as needed for official transactions without causing large market moves.

In 2010, the IMF argued that the RMB did not meet the "freely usable" criteria to be included in the SDR.

This focus on "widely used" and "widely traded" has proven the stumbling block for China. In 2010, the IMF staff argued that the RMB did not meet these criteria. The case for its inclusion is stronger now, but likely still to be mixed given the wide range of indicators that are examined and the inherent qualitative nature of the conditions. On economic grounds, this debate is a grey area without a definitive answer. Of particular concern to some is the lack of tradability in the United States; although the RMB has seventeen offshore clearing markets (including London and Germany), New York is not one of them.

It is important to note that freely useable is not the same as freely convertible. Certainly, the RMB is not freely convertible and is unlikely to be so for some time. Freely useable is an easier test than full convertibility, and potentially a large number of countries meet this test. But because of the gateway criteria, only China can be considered for addition to the SDR this time. Still, critics of China have focused on the lack of convertibility as reason to deny the Chinese request.

MARKETS WILL SPECULATE

There were once grand hopes that the SDR would grow into one of the major reserve currencies, but the private use of the SDR has been limited. With the rapid development of global foreign–exchange markets, investors can achieve the risk profile of the SDR reasonably easily and at low cost. Consequently, the SDR never achieved the scale or efficiencies to justify its widespread use.

Currency speculation might occur during the nearly year-long period between the announcement of the decision to add the RMB and the changeover to the new basket, if market participants form views about how the Chinese will manage the exchange rate during that period. China could allow large exchange-rate movements once a decision has been made (locking in a depreciation, for example), or China might err toward stability. I lean toward the latter view.

The introduction of a high-interest-rate currency into the basket will change the nature of the SDR. Because China's interest rate is higher than that of the major industrial countries and is expected to remain so on average, the introduction of the RMB into the basket with a 10 to 15 percent weight will raise the interest rate on the SDR by thirty to forty basis points, small relative to normal monetary-policy cycles but still considerable. This would be the case for any fast-growing developing country in the process of convergence—currency depreciation would be expected to offset inflation differences, but real interest rates will be higher than in industrial countries. From that perspective, the risk-free nature of the SDR as an asset does change, borrowers from the IMF will pay more, and the value for investors shifts as well.

THE POLITICS OF THE SDR

One argument for Chinese participation in the SDR, as for other decisions regarding international institutions, is that these types of decisions anchor the reform process in China by offering visible symbols of the government's commitment to reform. This argument has been made often by the Peoples Bank of China, for example, although this argument lost some credibility during the recent turmoil in Chinese markets. The subsequent herky-jerky market reaction by the government suggested an antireform bias (and provides an excuse for not liberalizing quickly). Nonetheless, the Chinese government does seem to recognize and acknowledge the need for a credible commitment to further reform in this area as part of the process on SDR inclusion.

The United States should support China making significant steps ahead of the IMF decision.

Opponents of adding the RMB to the SDR have expressed concern that it validates unfair trade and financial-services practices. For example, a June 2015 letter from Senators Chuck Schumer (D-NY) and Lindsey Graham (R-SC) to the IMF demanded that the RMB not be included in the SDR, arguing that the RMB remained significantly undervalued and that China's economic reforms and efforts to liberalize currency and capital flows had yet to go far enough. From that perspective, the announcement of a decision late this year, when it is possible that Congress will be considering the Trans-Pacific Partnership (TPP) and IMF quota reform, represents another communication challenge for the Obama administration, should the IMF decide to include the RMB in the SDR.

Good things could come out of the negotiation around the Chinese request. China has until now failed to report foreign-exchange reserves to international databases—e.g., currency composition of official foreign-exchange reserves (COFER)—and could be a lot more transparent in its reserve operations. The Fund should seek commitments on this score and it is likely to do so. The broader question is over where China is going on market reform and whether this milestone will support liberalization.

In the end, especially after the fiasco surrounding the U.S. objection to the establishment of the AIIB, it is important for the U.S. government to get this right. The U.S. position should support China making some significant steps ahead of the decision, including regarding transparency and continued moves to a more market-oriented exchange rate. The ultimate objective for the IMF will be a package of measures that can get the United States to "yes."

Looking Ahead: Kahn's take on the news on the horizon

Taper Tantrum 2.0?
Ahead of a Federal Reserve decision to raise interest rates, expected between September and December, there is increased worry about the implications for emerging markets.

Greece Negotiations Start Slowly
Negotiators are aiming for a mid-August agreement, but another bridge loan likely will be needed.

Brazil Worries
Concerns that Brazil will lose its investment-grade rating underscore rising economic concerns.