

## INCLUSION OF THE RENMINBI IN THE SPECIAL DRAWING RIGHTS BASKET: TECHNICAL AND ECONOMIC IMPLICATIONS

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*In October 2016, after a long and controversial review, the IMF included the renminbi in the special drawing rights (SDR) basket. On one hand, this amounted to recognition by a multilateral forum of the financial liberalisation undertaken by the Chinese authorities in recent years, while, for the IMF, it was a further step in the reform process it had launched in the 2000s, to increase the weight of the emerging economies in its governance. This article explains the main characteristics of the SDR, reviews the process that was followed to include the renminbi in the basket and examines the implications such inclusion may have for China, the IMF and the international monetary system (IMS) as a whole. It also discusses the channels through which the role of SDRs in the international financial system could be boosted, although the most important prerequisite for this is the firm support of institutions and the international community.*

### Introduction

In October 2016, after a long and controversial review, the IMF included the renminbi in the SDR basket, along with the US dollar, the euro, the Japanese yen and the pound sterling. This is the first time that a currency issued by an emerging country has been one of the constituent currencies of the SDR. The entry of the renminbi is a signal that the IMF considers that the Chinese currency has the same reserve asset status as the other currencies in the basket.

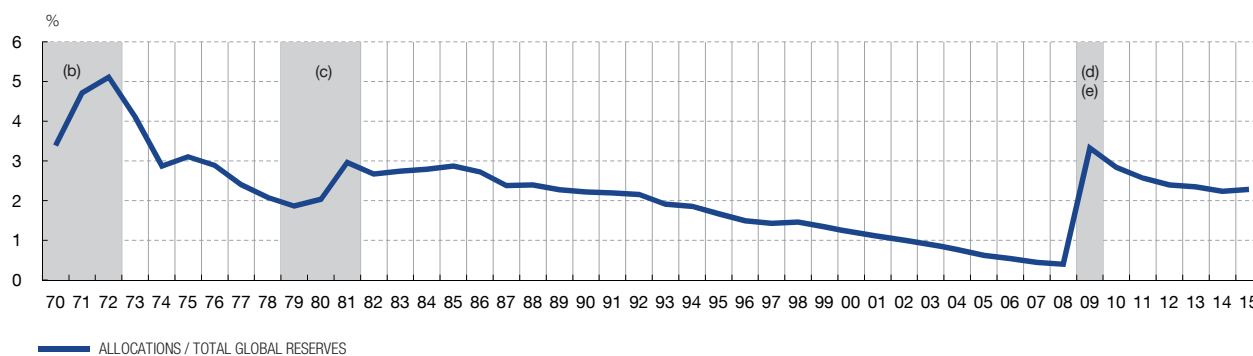
The inclusion of the Chinese currency in the SDR basket amounts to recognition by a multilateral forum of the financial liberalisation undertaken by the Chinese authorities in recent years and an incentive to press ahead with the reform agenda. Moreover, this entry provides an opportunity to consolidate the position of the renminbi as a reserve currency and to extend its use and trading beyond Asia, further developing the two key aspects for a currency to be admitted to – and retained in – the SDR. The support of central banks and international markets, which is fundamental to this internationalisation, will largely depend on the implementation of pending reforms.

For the IMF, the inclusion of the renminbi in the SDR currency basket is a further step in the reform process that it launched in the 2000s to raise the profile of the emerging economies in its governance, in order to reflect their greater weight in the world economy.<sup>1</sup> China currently has the third largest actual quota share, after the United States and Japan, and the second largest calculated quota share. The new basket is more in tune with an IMS in which the number of poles of attraction is multiplying, a setting that should, in principle, be more favourable to a relaunch of use of the SDR, a currency that was originally intended to be “paper gold” but ended up as a “paper tiger” (Boughton (2001)). However, greater SDR use will require more wholehearted promotion by the international financial community, led by the G20 and the IMF itself.

This article is organised into four sections and conclusions. The first section details the nature of SDRs and their main characteristics. The second section analyses the process

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<sup>1</sup> On IMF governance, see Moreno (2014).



SOURCE: Banco de España based on IMF data.

- a Shaded area corresponds to allocation periods.
- b First allocation for a total amount of SDR 9.3 billion.
- c Second allocation for a total amount of SDR 2.1 billion.
- d Third allocation for a total amount of SDR 161.1 billion.
- e Special allocation for a total amount of SDR 21.5 billion.

followed to include the renminbi in the SDR basket. The third section examines the implications of such inclusion for China, the IMF and the IMS. The fourth section reviews possible channels for boosting the role of SDRs.

#### Special drawing rights: preliminary issues

The IMF created SDRs in 1969 as an international reserve asset to supplement gold and the US dollar, before the end of the Bretton Woods fixed exchange rate system.<sup>2</sup> The SDR is neither strictly a currency nor a claim on the IMF, but rather a claim on currencies considered to be freely usable, as well as being the unit of account of the IMF and other international organisations. SDRs can only be held and used by IMF member countries, by the IMF itself and by certain prescribed organisations.<sup>3</sup>

The IMF allocates SDRs unconditionally. General SDR allocations are made in proportion to countries' IMF quotas and decided for successive periods of up to five years. General SDR allocations have only been made three times;<sup>4</sup> in addition there has been a special one-off allocation made for equitable reasons.<sup>5</sup> The IMF's Articles of Agreement also allow for cancellation of SDRs, but this provision has never been used. The total number of SDRs currently in circulation is 204.1 billion. SDRs represent around 2% of total world reserves (see Chart 1).

SDRs are low cost reserve assets<sup>6</sup>. IMF members pay interest on the SDRs that have been allocated to them and earn interest on their holdings at the same rate, which means that if a country has the same level of holdings and allocations, its interest charges are equal to

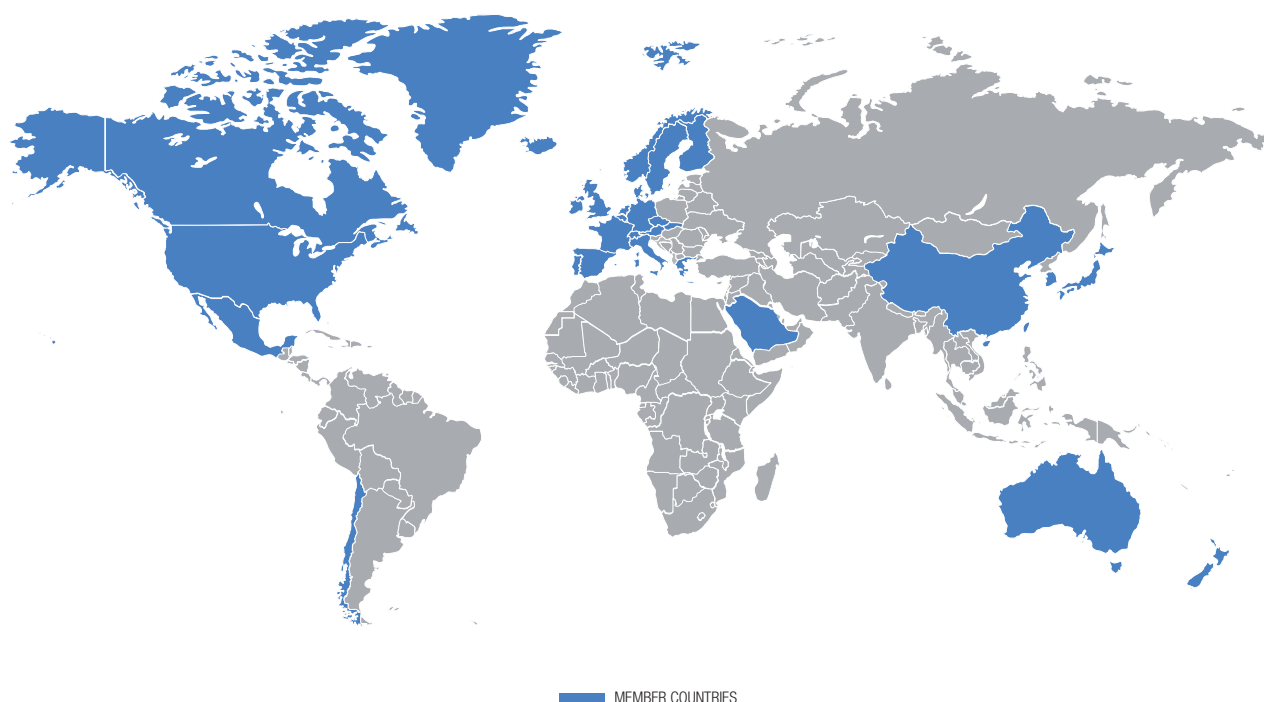
2 The value of the SDR initially coincided with that of the US dollar and was equivalent to 0.888671 grammes of fine gold. In 1973, when the main currencies shifted to a floating exchange rate system, SDRs were redefined as a basket of sixteen currencies (reduced to five at the beginning of the 1980s, and four with the introduction of the euro in 1999).

3 There are currently 15 prescribed holders: four central banks (including the European Central Bank); three multilateral monetary institutions (including the Bank for International Settlements); and eight development-promoting institutions (including the World Bank and various regional development banks).

4 The first allocation, for a total amount of SDR 9.3 billion, was distributed in 1970-72; the second, for SDR 12.1 billion, was distributed in 1979-81; and the third, for SDR 161.2 billion, was made in August 2009.

5 In September 2009, the IMF made a special one-time allocation of SDR 21.5 billion, provided for by the Fourth Amendment to the Articles of Agreement (approved in 1997, although not ratified until 2009). The purpose of this allocation was to enable all IMF members, at the time of approval of the Fourth Amendment, to have the same proportion of their quota (29.32%) allocated to them as SDRs, rectifying the fact that countries that joined the IMF after 1981 (more than one fifth of the current membership) had never received an SDR allocation until that year.

6 Holders pay a small charge to cover the operating costs of the department that manages SDRs.



SOURCE: International Monetary Fund.

its interest income. However, if a country's SDR holdings are greater (less) than its allocations, the country will earn (pay) interest on the difference. Interest is calculated at the SDR rate (see below) and settled on a quarterly basis.

IMF members trade SDRs, either to comply with their obligations to the IMF or to adjust the composition of their reserves.<sup>7</sup> The IMF acts as an intermediary to ensure that SDRs can be exchanged for other freely usable currencies, through of two types of transaction: (1) voluntary transactions between member countries; and (2) transactions through the designation mechanism (whereby countries with a strong external position purchase SDRs from those with weak external positions). Since 1987, voluntary transactions have ensured the liquidity of the SDR market. Chart 2 shows a map of the 31 members, as well as one prescribed holder (European central bank (ECB)), with voluntary trading arrangements in force.

The value of the SDR is determined by a weighted basket of currencies. The number of currencies is small to ensure its value is stable. Every five years, or earlier if circumstances warrant, the IMF reviews the composition of the basket, the weights of the constituent currencies and the financial instruments used to calculate the SDR interest rate. The weight of each currency in the basket is approved by the IMF during the five-year reviews and converted into fixed amounts of each currency.<sup>8</sup>

<sup>7</sup> In practice, most IMF loan disbursements and repayments are made using currencies other than the SDR, while the interest on such loans, the charge on SDR allocations, the remuneration of SDR holdings and, up to a point, payment of the reserve asset tranche of the successive quota increases (25% of each individual subscription) are usually made in SDRs.

<sup>8</sup> This conversion is carried out on the last business day preceding the date the new basket becomes effective (normally at year end); the currency amounts are determined in such a way that a) the value of the SDR expressed in US dollars is the same using the new basket as the value of the SDR in force on the day before the change in basket (the equalisation principle), and b) the weight of each currency calculated at the average exchange rate over the three-month period ending on the day before the change in basket does not deviate by more than half a percentage point (tolerance limit) from the weight approved by the IMF at the time of completion of the review.

The daily valuation of the SDR is carried out in two phases. First, the value of the SDR in terms of the US dollar is calculated as the sum of the fixed amounts of each currency valued in dollars. Second, the value of the SDR in terms of the other currencies is calculated using the representative exchange rates of these currencies against the dollar and the value of the dollar in SDR calculated previously.<sup>9</sup>

The SDR interest rate is determined weekly. It is based on a weighted average of representative interest rates on short-term (three-month) debt instruments in the money markets of the SDR basket currencies. This rate is used to calculate the interest paid (earned) by the debtor (creditor) countries of the IMF, and to be charged (paid) on individual SDR allocations (holdings).<sup>10</sup>

#### Inclusion of the renminbi in the SDR basket

On 3 October 2016, SDRs were officially quoted at 0.715470 to the US dollar, as compared with 0.716428 on 30 September. These two quotes correspond to the two different basket compositions, resulting from a lengthy review of SDRs performed internally at the IMF, which was concluded on 30 November 2015 with the inclusion of the renminbi in the basket with a 10.92% weighting.

Among the criteria for including currencies in the SDR basket are, first, that they are issued by the main world exporters, whether these be IMF members or monetary unions recognised by the IMF.<sup>11</sup> On balance of payments data for 2010-14, Chinese exports were the third largest, accounting for 10.5% of total exports, behind the euro area and the United States (see Chart 3).

Second, membership of the basket requires that the currencies be considered freely usable, according to IMF criteria.<sup>12</sup> This means that they are widely used to make payments for international transactions and widely traded in the principal exchange markets.<sup>13</sup> Determination of whether a currency is freely usable is based mainly on internal judgements, supported by quantitative indicators of an ad hoc nature, which do not take into account minimum thresholds.

According to IMF staff analysis carried out in 2015, the renminbi fulfilled the widely used and widely traded criteria (see Chart 4). The use of the renminbi in international payments had risen substantially since the previous review of the basket in 2010, and renminbi activity in foreign exchange markets in the principal trading areas (Asia, Europe and the United States) had, in the judgement of staff, grown sufficiently to be able to accommodate transactions of the magnitude required by the IMF.

#### INDICATORS OF EXTENSIVE USE

Based on 2014 data, the renminbi ranked seventh in terms of the share of official reserves, behind the other currencies in the SDR basket, and the Australian and Canadian dollars. In 2015 Q2, the renminbi ranked fifth in terms of its weight in international bank liabilities, behind

<sup>9</sup> The exchange rates used in the first phase are those provided by the Bank of England, observed at noon, or, in their absence, by the Federal Reserve Bank of New York or, as the case may be, by the ECB.

<sup>10</sup> Since October 2014, the SDR interest rate has been subject to a floor of 5 basis points.

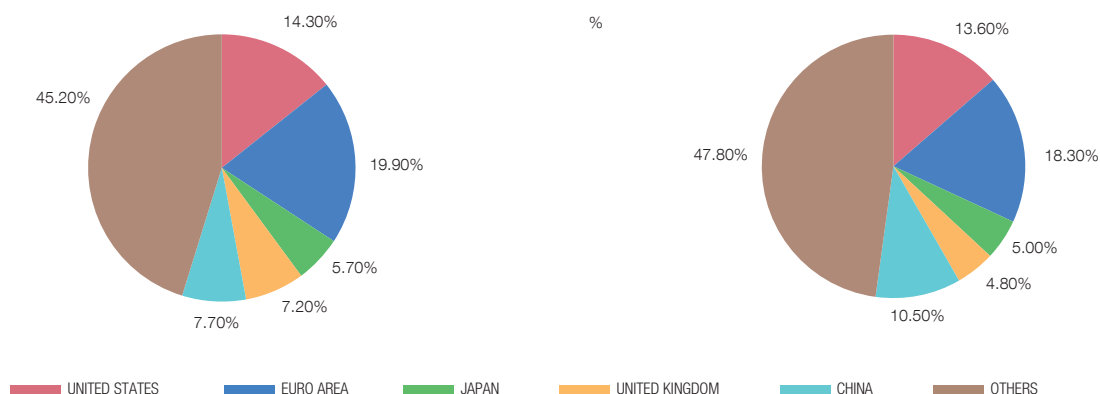
<sup>11</sup> The IMF takes as reference the average annual exports of goods and services in the five-year period ending twelve months before the revision of the basket. The calculations exclude trade within the monetary union considered.

<sup>12</sup> Defined in Article XXX (f) of the Articles of Agreement of the IMF on the explanation of terms.

<sup>13</sup> The concept of a “freely usable” currency was introduced by the second amendment of the IMF’s Articles of Agreement in 1978, although it was not applied until the revision of the basket in 2000, when the euro replaced the Deutsche Mark and the French franc. Note that the term “freely usable” is not the same as “freely floating” or “fully convertible”: a freely usable currency can be subject to capital controls, while a fully convertible currency may not necessarily be widely used and widely traded.

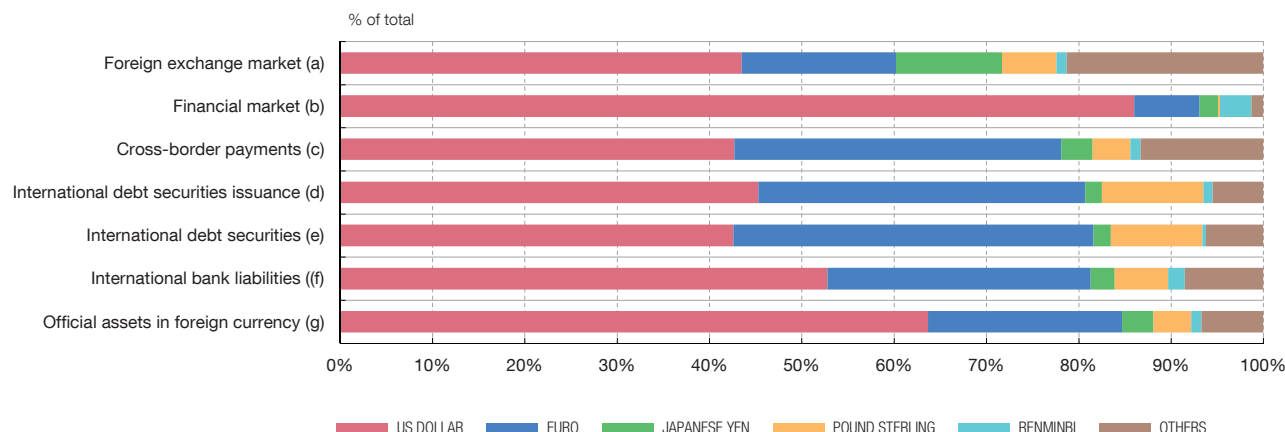
1 2005-2009

2 2010-2014



SOURCES: IMF, World Economic Outlook, Census and Statistics Department Hong Kong SAR.

WIDESPREAD USE AND TRADING OF RENMINBI



SOURCES: IMF, BIS, Haver Analytics and national sources.

- a Three-yearly survey of central banks, BIS. Data for 2013.
- b IMF calculations. Data for the period 2014 Q3-2015 Q2.
- c IMF calculations. Data for the period 2014 Q3-2015 Q2.
- d BIS Quarterly Review, BIS. Data for 2015 Q2.
- e BIS Quarterly Review, BIS. Data for 2015 Q2.
- f BIS, Haver Analytics and national sources. Data for 2015 Q2.
- g IMF survey on foreign currency assets. Data for 2014.

the other currencies in the basket, and ninth in the stock of international fixed income instruments, below those same currencies, the Swiss franc, the Australian and Canadian dollars, and the Swedish krona. The renminbi was the sixth most used currency in international debt issues in the first half of 2015, and the eighth most used in 2014-2015 for payments made through the SWIFT settlement system. Lastly, it was the third most used currency for documentary credit transactions in the same period, behind the US dollar and the euro.

INDICATORS OF EXTENSIVE TRADING

The renminbi's trading volume in foreign-exchange markets rose from 0.4 % in 2010 to a still modest 1.1% (see Chart 4) at end-2013, moving up from the seventeenth position to the ninth. The renminbi's trading volume is high in Asia, low (but growing) in Europe, and very low in North America. Hong Kong, Singapore and China account for 75% of all trading in this currency.

The Executive Board of the IMF approved the analysis by IMF staff and the recommendation to include the Chinese currency in the SDR basket, considering that the renminbi offered reasonable guarantees to the institution, its members and other SDR holders that there would be no constraints on transactions in this currency. The inclusion of the renminbi was underpinned by the progress made in the process of financial liberalisation (both internal and external) undertaken by China in recent years,<sup>14</sup> particularly during the year of the SDR review (see Box 1). Also favouring inclusion of the renminbi was the authorities' commitment to follow stricter transparency and data dissemination standards and multilateral initiatives on the provision of statistical information.<sup>15</sup>

The process for including the renminbi has received considerable political and institutional support. When the Chinese Premier Li Keqiang expressly asked the IMF's Managing Director Christine Lagarde to include the renminbi in March 2015, the head of the IMF stated that inclusion was only a matter of time. In July, the IMF welcomed the decision of the People's Bank of China to change the method for determining the renminbi's exchange rate for a more market-based one. In September, a joint Chinese-US statement following the meeting between Xi Jinping and Obama, helped to soften the earlier US stance, which was less accommodating of Chinese expectations than that of the main European countries. The emerging and developing economies were always more receptive to China's aspirations. Thus, on 30 November 2015, the Executive Board gave the green light for inclusion of the renminbi in the SDR basket.

According to the schedule for the five-yearly reviews of the SDR basket, the inclusion of the renminbi should have taken place on 1 January 2016, but was in fact delayed for nine months until 1 October. The reason for this delay was the decision adopted in August 2015 (prior to the decision to incorporate the renminbi) to extend the five-year period to allow for continuity in the IMF's operations using SDRs and thus avoid drastic changes in the composition of the basket at year-end, in the (very probable) event that the renminbi was incorporated into the SDR basket.

The SDR review also led to a change in the formula for calculating the weight of each currency in the basket. The formula which had been used since 1978 combined the exports and reserves variables with an implicit bias towards the former, and did not take into account the rapid growth of financial variables such as private capital flows in recent decades. The new formula assigns a 50% weight to exports and a composite financial indicator which combines reserves, foreign exchange turnover and banking liabilities and international debt securities, with equal weights. The new formula accommodates the renminbi, readjusting the weights of the other currencies in the basket (see Chart 5). The conversion of the weights approved by the Executive Board into fixed amounts of each currency was carried out on 30 September 2016<sup>16</sup> (see Table 1).

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<sup>14</sup> For detailed analysis of the reforms undertaken, see Cuadro-Sáez and Gallego (2016).

<sup>15</sup> In March 2016, the IMF announced that the Currency Composition of Official Foreign Exchange Reserves (COFER) database would separately identify the renminbi from 1 October 2016. This change will be reflected in the survey for 2016 Q4, to be published at the end of March 2017. The COFER shows aggregated data on the composition of foreign currency reserves in a sample of 145 reporting countries. The currencies which the COFER currently identifies separately are the US dollar, the pound sterling, the Japanese yen, the Swiss franc, the Canadian and Australian dollars and the euro.

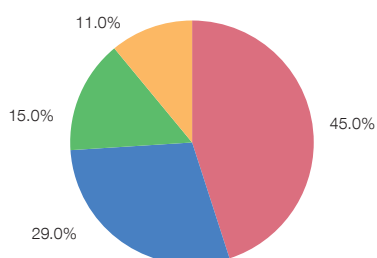
<sup>16</sup> The IMF also simplified the method for calculating the fixed amounts of currencies comprising the SDR basket, to be applied on the last business day before the change in basket. The new method guarantees the equalisation principle in a more straightforward way and with a lower tolerance limit (see footnote 8).

## WEIGHT OF EACH CURRENCY IN THE SDR BASKET

CHART 5

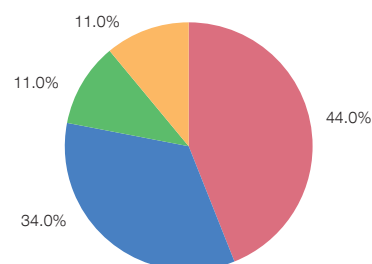
### 1 2000 REVISION

Weight in the basket



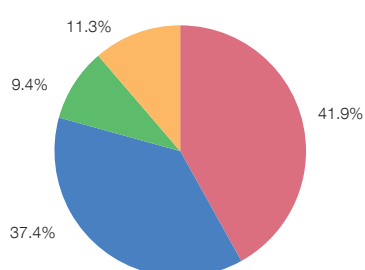
### 2 2005 REVISION

Weight in the basket



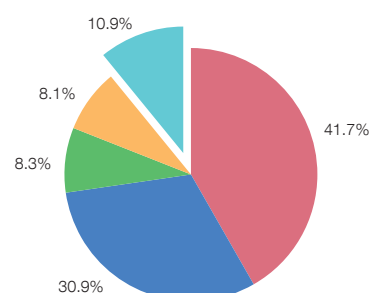
### 3 2010 REVISION

Weight in the basket



### 4 2015 REVISION

Weight in the basket



■ US DOLLAR ■ EURO ■ JAPANESE YEN ■ POUND STERLING ■ RENMINBI

SOURCE: IMF.

Lastly, between November 2015 and October 2016, the IMF and its member countries addressed a range of contractual and operational issues to adapt to the renminbi's new status in the SDR basket.<sup>17</sup>

### Main implications of the inclusion of the renminbi in the SDR basket

From China's standpoint, the inclusion of the renminbi in the SDR basket may aid progress in the internationalisation of the Chinese currency, speed up the reforms undertaken in its financial system and, in the longer term, underpin changes in the IMS. Since the start of the global financial crisis, the Chinese authorities have been working towards extending the use of the renminbi internationally. Its inclusion in the SDR basket is no doubt a major step towards promoting its use as an international reserve currency. However, the time it will take for the renminbi to acquire this status and to be in a position to compete with other reserve currencies will essentially depend on the confidence shown by the other central banks and international markets.

<sup>17</sup> To sum up: (a) determine the off-shore/on-shore renminbi exchange rates to be applied in the daily determination of the SDR exchange rate; (b) ensure that SDR holders can perform transactions using the renminbi, by opening on-shore accounts and establishing correspondent relationships with national institutions; (c) facilitate the use of the renminbi in the disbursements and repayments of IMF loans under the financial transactions plan (FTP) (see Box 2); (d) select the reference financial instrument for the renminbi at three to six months for the calculation of the weekly SDR interest rate and its interest rate derivative, respectively; (e) modify the composition of the IMF investment portfolios by currency to reflect the relative weight of the renminbi in the basket; and (f) guarantee the liquidity of the renminbi's foreign exchange market and fixed-income market around the dates of the change in basket.

Equalisation principle										
30.9.2016 Transition Exchange Rate (TER)						30.9.2016 Transition Exchange Rate (TER)				
Final amounts (1)	TER (a) (2)	Product (1) x (2) (3)	Implicit weight (3) / (4) (5)	Explicit weight (6)	Difference (6) – (5) (7)	Final amounts (8)	TER (a) (9)	Product (8) x (9) (10)	Implicit weight (10) / (11) (12)	
US dollar	0.582520	1.000000	0.582520	41.73	41.73	0.00	0.660000	1.000000	0.660000	47.28
Euro	0.386710	1.166000	0.431800	30.94	30.93	-0.01	0.423000	1.116600	0.472322	33.84
Chinese yuan	1.017400	0.149837	0.152441	10.92	10.92	0.00	0.000000	0.000000	0.000000	0.00
Japanese yen	11.900000	0.009886	0.117647	8.43	8.33	-0.10	12.100000	0.009886	0.119624	8.57
Pound sterling	0.085946	1.296100	0.111395	7.98	8.09	0.11	0.111000	1.296100	0.143867	10.31
		<b>1.39581 (b) (4)</b>	100.00	100.00	0.00			<b>1.39581 (b) (11)</b>	100.00	
3.10.2016 Average Exchange Rate (AER) (c) Margin of tolerance						3.10.2016				
Final amounts (13)	AER (a) (14)	Product (13) x (14) (15)	Implicit weight (15) / (16) (17)	Explicit weight (18)	Difference (18) – (17) (19)	Final amounts (20)	First rate (21)	Product (20) x (21) (22)	Implicit weight (22) / (23) (24)	
US dollar	0.582520	1.000000	0.582520	41.73	41.73	0.00	0.582520	1.000000	0.582520	41.70
Euro	0.386710	1.116650	0.431761	30.93	30.93	0.00	0.386710	1.124000	0.434662	31.09
Chinese yuan	1.017400	0.149828	0.152435	10.92	10.92	0.00	1.017400	0.149739	0.152344	10.89
Japanese yen	11.900000	0.009771	0.116280	8.33	8.33	0.00	11.900000	0.009867	0.117415	8.40
Pound sterling	0.085946	1.313967	0.112930	8.09	8.09	0.00	0.085946	1.288500	0.110741	7.92
		<b>1.395926 (b) (16)</b>	100.00	100.00				<b>1.397683 (b) (23)</b>	100.00	

SOURCE: International Monetary Fund.

- a Exchange rate for each currency expressed in US dollars.  
b The total may not be equal to the sum as a result of rounding.  
c Period from 1 July to 30 September 2016.

Hence, the presumption that a currency becomes an international reserve asset once it has been included in the SDR basket by decision of the IMF is not correct. The IMF, under a periodic review process such as that relating to the SDR basket composition, cannot dictate to countries in which currencies they should accumulate their reserves. If the G20 were to firmly promote the renminbi from 2017 (unlikely), it could become a more attractive option as an international reserve currency. In any event, the inclusion of the renminbi offers the possibility of further reducing the dependence of SDRs on the dollar and paving the way for greater diversification of reserve assets.

The use of the renminbi as a means of international payment is also a key aspect of its internationalisation. In the short term, it will foreseeably continue to play a minor role, but in the longer term, China must strengthen the role of the renminbi in international markets, maintaining the pace of financial liberalisation undertaken, in order to create non-trade demand for the renminbi.

The Chinese authorities are aware that their economy's financial constraints seriously hinder the rebalancing of economic growth, and that the sooner they undertake the necessary



reforms for the renminbi to attain the “quality standards” of other currencies in the SDR basket, the sooner their country will have a fully open and comparable financial system.

In addition, China has on a number of occasions expressed dissatisfaction with the US dollar’s dominant role as a reference currency in the IMS, both for economic and geopolitical reasons. In this regard, it has pushed for greater use of SDRs as an international reserve currency, guaranteeing a settlement system between the SDRs and the other currencies used in international trade and financial transactions.<sup>18</sup> However, it seems unlikely that the use of SDRs will increase in the short term, since reserves in this currency only represent around 2% of total world reserves. Moreover, it is difficult to distinguish the Chinese authorities’ multilateral strategy in favour of reforming the IMS from its unilateral strategy to internationalise the renminbi, although its inclusion in the SDR basket may serve both purposes.

From the IMF’s viewpoint, the addition of the renminbi means a more diversified and representative SDR basket, which contributes to keeping the Fund at the epicentre of the IMS.

From the standpoint of the IMS, the inclusion of the renminbi heralds a more diversified system. China has been the largest export country in Asia since 2000,<sup>19</sup> consolidating the renminbi as a reference currency in east Asia and the Philippines, ahead of the US dollar and the euro. The change of the renminbi to international currency status in the long term could transform the current IMS into an increasingly multipolar one, in which the dollar, the euro and the renminbi could coexist. The objective of having an international system based on more than one currency is to minimise risk and uncertainty and provide greater stability.

#### Outlook for the official and private use of SDRs

The question of how to give SDRs a more central role in the IMS and the global financial system in general is not new. However, the renminbi’s inclusion in the SDR’s basket of currencies has rekindled the debate. In 2016, the G20 – under China’s presidency – and the IMF began discussions on several fronts to explore the additional uses SDRs could have, both in the official market and in private financial markets. These discussions also sought to address the question of the extent to which a wider use of this currency could help improve the functioning of an IMS that is increasingly multipolar and interconnected. The debate will continue in 2017 under the German presidency of the G20.

There is scope for increased use of the SDR for all three of its potential functions: (1) as a reserve asset issued by the IMF it can help limit the accumulation of reserves and global imbalances; (2) as a unit of account – for the denomination of prices of goods and services as well as for statistical and accounting purposes – it can facilitate the comparability of information and help reduce the impact of exchange rate volatility; and (3) as the currency for SDR-denominated tradable financial assets, it could boost the supply of safe global assets and foster the diversification of financial instruments.

#### OFFICIAL USE OF SDRs

The SDR was created in 1969 as a composite reserve asset issued by the IMF, but has only played a small – almost insignificant – role in the IMS. After almost half a century, holders of SDRs – all of them official – still consider SDRs to be an imperfect substitute for other reserve assets, as a result of their limited use and the narrow and shallow market for them.

<sup>18</sup> See Zhou (2009) and Anderlini (2009).

<sup>19</sup> See Campanella (2014).

The SDR issuance allowed under the IMF's statutes, which is intended to cover long-term global liquidity needs that warrant the supplementing of the aggregate volume of existing reserves,<sup>20</sup> is insufficient to meet members' individual liquidity needs and tends to be concentrated in countries that already have adequate reserves or are reserve currency issuers.

The general allocation carried out in August 2009, which was the largest by the Fund to date (161.2 billion SDRs), was part of the multilateral response to the global financial crisis. Nevertheless, its size was small relative to levels of that year's global GDP (0.3%), trade (1%) and reserves (3%), and its impact negligible. More than half of the volume issued was allocated to advanced countries that were reserve asset issuers; approximately a third was shared out between emerging and developing countries; and almost 30% of this group opted to sell its SDRs through the voluntary market or used them to settle financial obligations directly with the Fund.

Some of the measures put forward to stimulate the official use of SDRs are simple, such as: (a) setting up a group of independent experts to advise the IMF on the need to issue SDRs and the frequency of issues; (b) allowing countries with surplus SDRs to grant SDR-denominated loans individually or collectively to countries with external financing needs;<sup>21</sup> (c) bringing back the reconstitution requirement, whereby IMF members are obliged to balance the volume of their SDR holdings with that of their accumulated allocations within a specified timeframe, so as to give more liquidity to the voluntary SDR market;<sup>22</sup> or (d) setting SDR interest rates daily, rather than weekly, to enable more finely tuned continuous valuation of SDR-denominated assets and hedging strategies.

In the past (IMF, 2011) the IMF has weighed up a number of more radical options, implementing which would require changes to its Articles of Agreement. These have included issuing contingent SDRs and holding them – wholly or partially – on deposit until a shock occurred; distributing SDRs selectively to countries with low levels of preventive reserves, relative to a particular benchmark,<sup>23</sup> or making the allocation of SDRs conditional upon the adoption of what the Fund considers appropriate policies. There is little internal support for these measures, however. For example, selective SDR issues are not linked to quotas, such that they deviate from the generally accepted principle that the IMF's relationships with its members should basically be guided by their quotas. Moreover, these issues tend to blur the distinction between a general (unconditional) allocation and a (conditional) loan from the Fund and, therefore, have an impact on the assessment of the adequacy and composition of the institution's financial resources.

#### THE USE OF SDRs AS A UNIT OF ACCOUNT

SDRs are already used for reporting financial and statistical information, and for calculating certain services, although their use in this area is minimal. By way of example, China publishes information on its international reserves in SDRs, the Bank for International Settlements (BIS) uses SDRs for its financial statements, and the tolls paid for ships to pass through the Suez Canal, and air carriers' compensation payments for luggage claims under the Montreal Convention, are also expressed in SDRs.

20 Article XVIII of the Articles of Agreement of the IMF on the Allocation and Cancellation of Special Drawing Rights.

21 In the financing for development area, see, for example, the philanthropic use of SDRs discussed in Soros (2002)

22 Up until 1981 the reconstitution requirement obliged IMF members to maintain average daily holdings of SDRs of no less than 30% of their net cumulative allocation (subsequently 15%) over a five-year period. Under current voluntary purchasing arrangements a volume of holdings of between 65% and 135% of net cumulative allocations is projected.

23 Since 2011 the IMF has had a new analytical framework to assess reserve adequacy, which is subject to periodic revision.

Using SDRs makes it easier to compare data and reduces the impact of exchange rate volatility. However, it is subject to the effects of the quinquennial review of the SDR basket, in terms of the currency composition, weight of each currency, and underlying financial instruments.

The issuing of financial assets (securities, deposits, etc.) denominated in SDRs, which began in 1975 and was discontinued in 1981, has recently attracted renewed attention following the inclusion of the renminbi in the SDR's basket of currencies. In September 2016 the International Bank for Reconstruction and Development (IBRD), which belongs to the World Bank Group, placed bonds with three-year maturities worth 500 million SDR (approximately 700 million dollars) on the Chinese interbank market, with annual coupon payments and principal repayments in renminbi.<sup>24</sup>

These instruments, issued and maintained by a variety of public and private agents, allow the exchange rate and interest rate risk inherent in securities denominated in a single currency to be reduced, given the stability offered by the SDR's composition as a weighted basket of currencies. However, the feasibility of this option depends on broad and deep secondary markets, with adequate transaction settlement systems, and with a mechanism for managing the effects of the periodic redefinition of the basket mentioned above.

Although not currently planned, the possibility of the private sector's holding and trading SDRs directly would enhance their quality as a reserve asset, insofar as central banks could use them in their foreign exchange intervention operations, giving SDRs a currency status they lack at present, increasing the liquidity of this market considerably and facilitating the development of financial instruments entirely denominated and implemented in SDR.

As mentioned, SDRs currently play a very minor role. Determined political, legal and operational steps need to be taken if greater use is to be made of SDRs in the IMS. However, there does not currently appear to be any strong commitment to taking these steps at present. The overall impression is that the interest in bolstering the use of SDRs stems more from the wishes of certain G20 countries, in particular the emerging economies, led by China, than from members as a whole or the issuing institution itself. For now, the IMF has made any decision as to whether to issue more SDRs (or cancel some of those already issued) conditional upon the outcome of this debate and the analysis of the appropriateness of its lending instruments and the adequacy of its financial resources in the broader context of the global financial safety net.<sup>25</sup>

## Conclusions

The renminbi currently plays a relatively minor role as a reserve currency and an international means of payment. However, it has considerable potential to achieve a stronger global role in the medium term, paralleling the size of China's economy, its volume of exports, and its increasing integration with international financial markets. The addition of the renminbi to the SDR basket is a major step towards the internationalisation of the Chinese currency and supports the deepening of reforms to the country's financial system. At the same time, it also increases the multipolarity of the IMS.

However, the renminbi's inclusion in the SDR is a necessary – but not sufficient – condition for its becoming a global currency. Firm steps also need to be taken to develop and open

<sup>24</sup> In October 2016 the Hong Kong subsidiary of Standard Chartered Bank obtained authorisation from the People's Bank of China to make the first private issue of bonds on the interbank market, for a value of 100 million SDR (\$140 million) with settlement in renminbi.

<sup>25</sup> On this point see Denbee, Jung and Paternò (2016), and Garrido, Moreno and Serra (2016).

up the Chinese financial system. In any event, it seems clear that the rate and intensity of this opening up needs to be matched to the possibilities of China's macroeconomic situation, the complexity of which, particularly in the context of the change in growth model the authorities are seeking to implement, needs be taken into account. Similarly, the need to safeguard financial stability should be present in financial liberalisation decisions.

Meanwhile, the SDR's role following the renminbi's addition to the basket remains marginal. Its official use as a reserve currency, its use as a unit of account, and its use in the issuance of financial assets traded in SDRs are the main routes for increasing the relevance of the IMF's 'currency' both among IMF members and in private markets. However, the international community needs to be firmly committed to steps in this direction, and at the moment this commitment does not appear to be sufficiently strong.

In any event, it will be necessary to remain attentive to the analysis and debates on the future of SDRs taking place in 2016 and 2017 at the G20 and the IMF to ascertain the possible scope of this renewed interest in the Fund's reserve asset.

13.12.2016.

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The reforms adopted by the Chinese government to deregulate the economy have made significant progress in recent years on both the domestic and international fronts.

On the domestic side, the main development has been the deregulation of interest rates. Previously, the People's Bank of China set the interest rates institutions were to apply to both loans and deposits. Since July 2013, however, institutions have been free to set the minimum interest rate on their loans, which has led to increased competition between them and lower borrowing costs. Additionally, the liberalisation of deposit interest rates, which culminated in October 2015, represented a key change in internal deregulation, as deposit interest rates had been very low (or even negative) in the past. The People's Bank of China also aims to develop new monetary policy instruments to set up an interest rate corridor similar to that of Japan or the euro area. There has been less progress as regards the ownership structure of the banking system, as large public sector entities account for over 50% of bank assets.

Since the end of 2014 China has been supporting the process of external liberalisation with the aim of making the renminbi a

reserve currency. To this end, it introduced reforms on two fronts: firstly, opening up the capital account and secondly, encouraging interest rate flexibility. Capital account openness was promoted by connecting the Shanghai and Hong Kong stock markets and lifting some of the main controls on capital inflows. Exchange rate liberalisation has meant a shift from a de facto managed floating rate against the dollar to one based on a basket of currencies.<sup>1</sup>

Despite the reforms undertaken, China<sup>2</sup> still has work to do on making its exchange rate more flexible in order to arrive at a market-based exchange-rate system by 2018. This increased exchange rate flexibility will need to be supported by progress towards a market-based monetary policy operations framework and debt management in the short term to avoid excessive volatility. China also needs to continue working on liberalising the capital account.

<sup>1</sup> This basket contains 13 currencies and gives greatest weight to the US dollar (26.4%) followed by the euro (21.4%).

<sup>2</sup> According to the IMF's recommendations in its 2016 Article IV consultation.

The financial transactions plan (FTP) is the mechanism through which the Fund finances its lending and repayment operations in the General Resources Account (GRA). Countries are selected to participate in the FTP in proportion to their quota based on the strength of their balance of payments and their reserve position. Each quarter the Fund puts forward a list of members meeting the conditions and the Executive Board then takes a decision based on this list.

The financial resources provided by the members of the FTP are used to finance disbursements to members requiring a loan, while payments made by borrower countries are repaid to FTP members. The amount for transfers in the transactions plan is based on the expected volume of disbursements to member countries with borrowing requirements. Receipts in currencies are estimated on

the basis of scheduled repayments over the same period.

The currencies of the selected members are considered usable for loans and repayments during the quarter. When one of these currencies is used in loan transactions, the Fund decides the amount of this currency based on the exchange rate against the SDR two business days before the value date of the transaction. If the currency used in the transaction is not freely usable, the FTP members are obliged to convert it into a freely usable currency. The amount of freely usable currency is calculated based on the exchange rate of the freely usable currency against the SDR. As mentioned, on 1 October 2016, the renminbi was added to the list of freely usable currencies alongside the US dollar, the euro, the yen and the pound sterling.

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