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The IMF's Special Drawing Right and China's Renminbi

Overview

During 2015, The International Monetary Fund (IMF) reviewed the basket of currencies used to determine the value of the Special Drawing Right (SDR), the international reserve asset created and used by the IMF. Following a recommendation by IMF staff, the IMF Executive Board decided on November 30, 2015 to include the Chinese RMB in the SDR basket as a fifth currency, alongside the U.S. dollar, euro, British pound, and Japanese yen. The decision will be effective on October 1, 2016.

What is the SDR?

The SDR is an international reserve asset comprised of a basket of major currencies. Created by the IMF in 1969, SDRs are allocated to IMF members to supplement their existing official reserves. In addition to its role as an international reserve asset, the SDR serves as the unit of account for the IMF and a number of other international organizations. Member country contributions to the IMF, as well as IMF financial assistance to member countries, are valued in SDRs.

All 189 IMF member countries, the IMF itself, and various international organizations utilize SDRs. Although not an international currency in and of itself, SDRs can be exchanged for hard currency and can be used in international transactions by central banks and other monetary authorities. Private sector holding of SDRs is prohibited.

IMF members receive interest on their SDR holdings and pay charges on their cumulative allocations of SDRs at the same interest rate. The SDR interest rate is a weighted average of 3-month sovereign bill rates of these currencies.

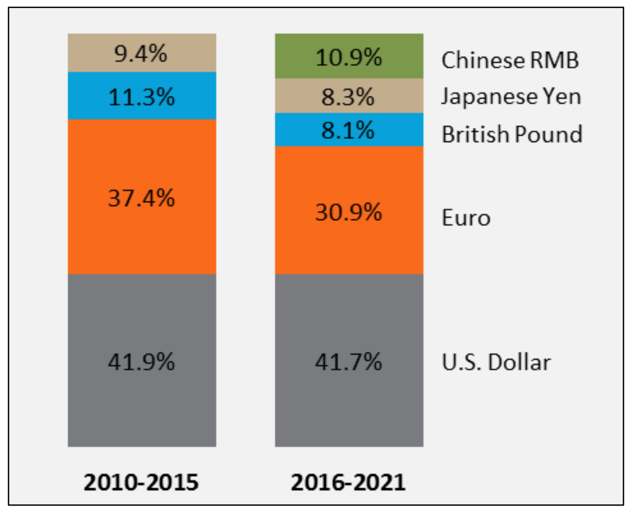
SDRs represent a small percentage of global foreign reserves. Total currency reserves were $10.94 trillion at the end of December 2015, according to most recent IMF figures. Of the countries that report the currency composition of their foreign exchange reserves (allocated reserves), the U.S. dollar accounts for 64.1% percent of the total. By contrast, there are currently around SDR 204.1 billion outstanding (around $289 billion dollars). Thus, SDRs comprise 2.6% of total foreign exchange reserves, equivalent to the percentage of global foreign exchange reserves held in the Canadian dollar and the Australian dollar. Since their creation in 1969, the total amount of SDRs has not exceeded 7% of total foreign exchange reserves.

SDR Valuation and Review

In 2000, the IMF Executive Board adapted criteria for determining the SDR basket of currencies. It included four currencies issued by members or currency unions whose exports of goods and services had the largest value over a five-year period and were determined by the IMF to be "freely usable."

The value of the SDR is currently equal to a weighted basket of four currencies (U.S. dollar; euro; Japanese yen; British pound sterling). The SDR basket is revaluated every five years. Currently, one SDR is equivalent to around $1.42. In its 2015 review, the IMF assigned a 10.92% weight to the RMB in the new SDR basket, which will go into effect on October 1, 2016 (**Figure 2**). The next review of the SDR basket is to be completed by September 30, 2021.

Figure 1. Composition of the SDR Basket



Source: International Monetary Fund

The 2015 SDR review consisted of two components: (1) a technical review by IMF staff to determine whether the RMB meets the SDR criteria; and (2) a vote by the IMF Executive Board. Decisions to change the valuation method are based on a 70% majority vote. Thus, the United States with 16.74% of the total voting power could not prevent the RMB's inclusion in the SDR basket (if it so chose) without the support of other IMF members.

Export Criterion: The level of a country's exports provides an initial test of its currency's potential for inclusion in the SDR basket. This criterion ensures that the SDR basket comprises currencies that play a central role in the global economy.

Freely Usable Criterion: In addition to meeting the export criterion, a country's currency must be "freely usable," meaning that it is widely used to make payments for international transactions, and is widely traded in principal exchange markets. According to the IMF, the concept of a freely usable currency concerns the actual international use and trading of currencies, and is different from whether a currency is either freely floating or fully convertible. Thus, a currency can be widely used and widely traded even if it is subject to capital account restrictions. Conversely, a freely floating and fully convertible currency may not necessarily be freely usable.

The decision of whether a currency is freely usable is informed by the level of official reserves denominated in that currency, as well as consideration of other indicators of the breadth and depth of the currency's use and trading in global financial markets. These include the currency denomination of international debt securities, international banking liabilities as indicators for assessing wide use, and the volume (turnover) of transaction in foreign exchange markets. However, the indicators are not applied mechanistically and the freely usable determination ultimately requires judgment by the IMF Executive Board.

China and SDRs

The third largest exporter behind the United States and the Euro area, China, meets the export criterion for inclusion in the SDR basket. China's share of global exports of services was 11% over the 2010-14 period, over double that of Japan (5%) and the United Kingdom (4.9%). Turning to the freely usable criterion, despite achieving full current account convertibility in the late 1990s, China still maintains capital account controls, which has hindered its international usage.

According to the IMF, failure to meet the "freely usable" criterion prevented the RMB from inclusion in the SDR basket in 2010. Chinese authorities' recent efforts for gradual opening of the capital account are among the key areas of consideration by IMF staff and member countries. A general consensus among economists is that the RMB is a "mixed-bag," meeting some but not all the criteria to be considered "freely usable."

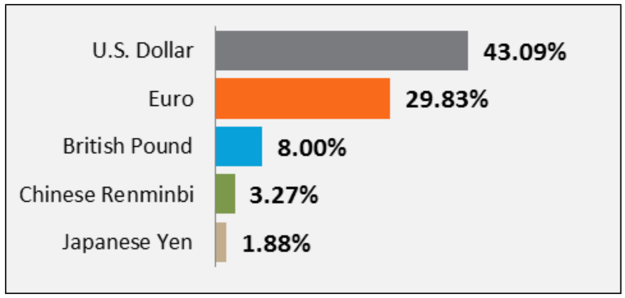
The "freely usable" criterion comprises two key tests: whether a currency is widely used for international transactions and whether it is widely traded on international financial markets. Regarding the first criteria, figures provided by The Society for Worldwide Interbank Financial Telecommunication (SWIFT) show that the RMB is among the five most widely used currencies for international payments (**Figure 2**) and is the second most widely used currency for letters of credit.

It is less clear whether the RMB can be considered "widely traded." The IMF's main indicator for determining whether or not a currency is widely traded is transaction volume involving the exchange of that currency. According to figures compiled by the Bank for International Settlements (BIS), the four current SDR currencies (dollar, euro, pound, yen) account for roughly 80% of total turnover.

While overall levels of RMB turnover remain modest, BIS data (available through 2013) shows that the RMB's share of total turnover has increased. The RMB's total share increased to 1.1% (daily average turnover of $120 billion), up from 0.4% (34 billion in 2010). More recent information, including regional and national surveys, as well as transaction data from SWIFT suggests a continued rise since 2013 in the RMB's share of transaction volume. During March 2016 (the most recent month for which data is available), the RMB was the 4th most frequent currency used for international transactions (**Figure 2**).

Figure 2. Top Five Global Payment Currencies

Percentage of Global Payments, March 2016



Source: SWIFT

Since 2009, China has implemented policy measures to internationalize the RMB. These reforms address three main areas: gradual opening of the capital account for foreign private and official investors, steps to strengthen the domestic financial system, and offshore liquidity support through improvements to cross-border payments infrastructure and central bank swap lines.

U.S. Policy and Implications

In September 2015, the Obama Administration released a statement saying that the United States supports the inclusion of the RMB in the SDR basket "provided the currency meets the IMF's existing criteria in its SDR review." Similar statements have been made by other European and Asian officials. Including the RMB in the SDR basket is symbolically important to China. It signals that the IMF believes that the RMB possesses the necessary attributes to become an international reserve currency.

At the same time, a decision by the IMF to include the RMB in the SDR basket does not grant reserve currency status to the RMB or directly increase demand for renminbi assets from central banks and international investors. The decision of whether or not to hold RMB and RMB-denominated assets will be made after individual assessments of the depth and liquidity of Chinese financial markets by central banks and financial market participants.

Of potential broader interest to policymakers and analysts is whether the inclusion of the RMB in the SDR basket reflects a shift in global attitudes on the necessary attributes of an international reserve currency. Including the RMB in the SDR basket affirms that a currency can be an international reserve asset without being fully convertible. Although China has made substantial progress in opening its capital markets and financial sectors to investments, internationalization along these measures stop well short of a fully open capital account.

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