After RMB inclusion in the SDR: Why does China want the RMB to be a reserve currency?

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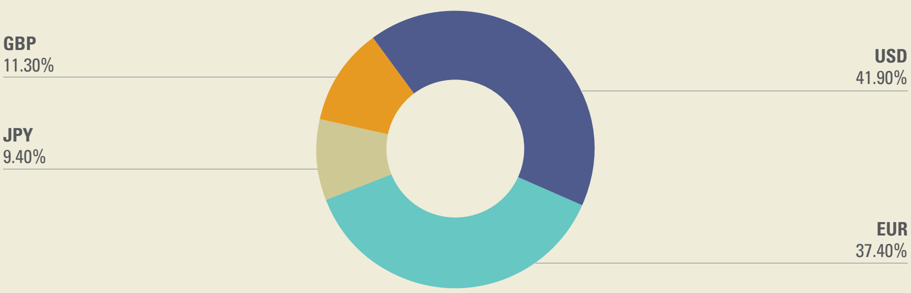
"It does not matter how slowly you go as long as you do not stop" — Confucius

This quotation could very well apply to the Chinese Renminbi (RMB) and its gradual path toward reserve currency status. On November 30, the Executive Board of the International Monetary Fund (IMF) will likely approve a staff recommendation to include the RMB in the basket of currencies that compose the SDR (Special Drawing Rights — an international reserve asset used only by central banks, the IMF and a few other official institutions). The RMB will therefore join four other currencies (USD, EUR, GBP and JPY) in this perceived exclusive club. The RMB's expected share in the SDR basket should be approximately 10–15%, depending on any new methodological changes chosen by the IMF. This decision will take effect by 1 October 2016.

By approving the RMB inclusion, the IMF has formally expressed the view that the currency meets the criteria for SDR inclusion; i.e. it is widely used in global trade and "freely usable." Given China's prominence in global trade, it is the latter point that is controversial given that several capital controls remain in place. There has been much focus on why the Fund may have softened the eligibility criteria. The criteria partially reflect that China is the first middle-income country in the modern era to be a candidate for reserve currency status.

Thus far, if you consider the 20th century rise of the yen, Deutsche mark, the US dollar or even UK sterling in the 19th century, all currencies joining this exclusive club emerged from industrialized economies. To put it in numbers, West Germany's and Japan's GDP per capita, on a purchasing power parity (PPP) basis, were about 85% and 65% of US levels, respectively, in the 1970s when their currencies were increasingly used as a store of value. By contrast, in 2016, China's GDP per capita (PPP) is estimated to only be roughly 25% of the US equivalent.[1] This raises the broader question of why China seeks reserve currency status at all.

Figure 1: Current Weight of SDR Basket Currencies – Before RMB Inclusion



Source: IMF as of 31 October 2015.

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What is a Reserve Currency?

It is a currency that is held in significant quantities by governments and institutions as part of their foreign exchange reserves. As Maurice Obstfeld, currently Director of Research at the IMF, has written: "International reserve holdings provide a country with unconditional liquidity in case of need. A need can arise due to a sudden stop in inflows, problems of sovereign borrowing or refinance, depreciation on the exchange rate, or banking system illiquidity."[2] Among other things, reserve currencies are generally characterized by broad and deep capital markets, floating exchange rates, scale, credible policy frameworks, voluntary private holdings of the currency, and liquidity.

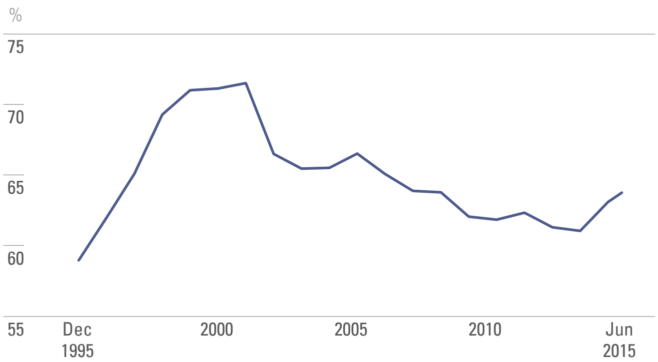
Modern reserve currencies are not backed by hard assets, e.g. gold, as was the case under the Bretton Woods system until 1971 when the US dollar was fixed to gold. Since then, reserve currencies have become fiat currencies, therefore resting on the confidence of buyers, and buttressed by the currency's widespread use in trade and transactions as well as a large supply of denominated financial assets.

Immediately after World War II, the United States accounted for roughly 50% of global output, and the US dollar was the world's pre-eminent reserve currency. Following the post war industrialization and rapid growth of Japan and Germany, the Japanese yen, and Deutsche mark (up to 1999) and subsequently euro offered alternatives to the dollar. In both cases, monetary authorities were ambivalent about becoming reserve currencies because their Treasuries and Central Banks feared "destabilizing" foreign exchange inflows and outflows. Nonetheless, the dollar's share of global FX reserves gradually fell over several years.

However, the share of the yen and the euro in global FX reserves has fluctuated. The eurozone crisis post-2008 reflects concerns about the structure of the currency union and global holdings of euro declined from the mid-2009 high of nearly 28% of reported reserves. And since the early 1990s, Japan has actually actively discouraged the appeal of the yen as a reserve currency by complicating the sale and purchase of yen securities. Japan's fear of the yen's increased status as a reserve currency highlights that it not only bestows great benefits, but also carries risks to issuing countries.

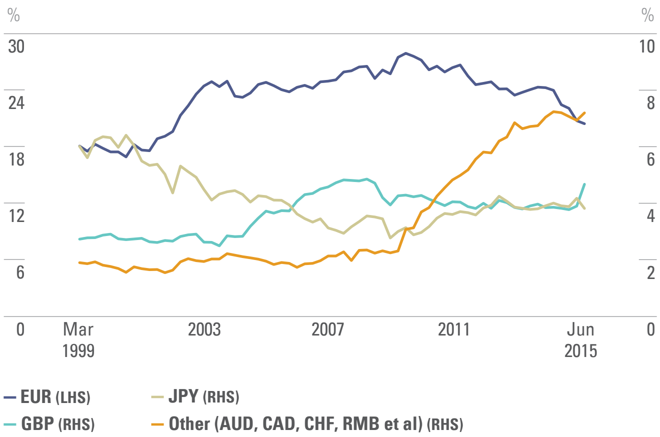
China has evidently made the calculation that the benefits of being a reserve currency outweigh the costs. So what are the benefits and costs?

Figure 2: US Dollar Share of Global Official Foreign Exchange Reserves since 1995



Source: IMF COFER (Composition of Official Foreign Exchange Reserves) as of 30 June 2015.

Figure 3: Non-USD Share of Global Official Foreign Exchange Reserves since 1999



Source: IMF COFER (Composition of Official Foreign Exchange Reserves) as of 30 June 2015.

Potential Benefits for China

SDR inclusion does not automatically confer reserve currency status, which is ultimately determined by the willingness of foreign central banks to hold the issuer's currency and financial instruments. It is only one small step toward reserve currency status, which is ultimately determined by the voluntary use of the currency. Figure 3 shows the major currencies recently used as global foreign exchange reserves. The biggest beneficiary of this status has been the US, although smaller economies with popular currency usage such as Australia, Canada and Switzerland also enjoy some of the advantages of reserve currency status. These include:

- **Better financing, i.e. the ability to borrow in one's currency both domestically and internationally.** The 'original sin' of emerging market crises is foreign currency borrowing, either by the sovereign or by the private sector. As a reserve currency, both sectors in China would be able to issue most of their debt in RMB, removing the potential exchange rate risk that could suddenly trigger a balance of payments crisis with a spike in debt servicing costs. In addition, an expected outcome would be increased liquidity in domestic capital markets, creating more diverse financing options at competitive rates. In fairness, China's borrowers have not lacked access to affordable finance during the past few decades. But, just as is the case in the US, large foreign official holdings of Chinese government debt would reduce China's borrowing costs.

- **Seignorage.** This phenomenon refers to income earned by a central bank by issuing currency that others wish to hold. In practice, the Chinese central bank would earn seignorage by issuing a non-interest bearing liability — cash — while being able to invest in Chinese government bonds. This phenomenon is also frequently referred to as a positive 'carry' for governments. For the US, varying estimates suggest this amount equals between $10 and $25 billion a year in profits or roughly 0.1% of GDP given the current low interest rate environment.[3] Seignorage profits in China would grow as holdings of RMB cash grew.
- **Lower transaction costs and the ability for Chinese companies and individuals to pay for purchases in their own currency.** The most immediate beneficiary tends to be the sovereign as demand for government bond issues is not only driven by yield and maturity considerations, but also by general currency demand. These lower borrowing costs are then typically cascaded throughout the economy and bring about a wider drop in borrowing costs across the economy. Also, there would be some savings from lower transaction costs due to the high share of foreigners operating in RMB. This would be most visible in trade finance, but other areas would also benefit.
- **Policy flexibility.** The lower borrowing costs impose less market discipline on the fiscal policy of reserve currency holders, i.e. they enjoy the 'benefit of the doubt'. However, there are other policy advantages such as a lessened need to hold large reserves of foreign exchange. While China's foreign exchange (FX) reserves of $3.5 trillion are equal to about 33% of GDP, the US holds forex reserves of only about 1% of GDP. The large eurozone members, too, also have forex reserves levels in the lower single digits as a percentage of GDP. Even Japan had similarly low levels during the height of the Yen's usage as a reserve currency in 1991.

  Being a reserve currency reduces the need to "self insure" by holding large FX reserves. Also, holders of large FX reserves frequently sterilise their FX inflows. In many cases, they earn less on their FX holdings than the interest they have to pay on domestic currency sterilization bonds. The "negative carry" can worsen general government budgets.
- **Reduced reliance on the US dollar, and facilitation of the overseas expansion of Chinese firms and financial institutions.** Much of the world's financial architecture relies on the US dollar system, in effect routing the majority of global payments through the US. At times, the US has used this feature to engage in extraterritorial judicial proceedings or the basis for sanctions regimes. Chinese policymakers would like to reduce their reliance on the US dollar and believe that enlarging the RMB zone would help Chinese firms operate and finance activities abroad.
- **Financial Market Development.** Precisely because reserve currencies need to be able to draw on deep financial markets, with a healthy supply of denominated financial assets, especially fixed income securities, it implies that China would have to advance the development of its financial system. External demand would help in this process, as it would work as a structural stimulus to capital market growth. However, the broader question remains around the timing of financial liberalization and Beijing's history of tight state control over capital allocation makes this, at best, a very gradual proposition.
- **Consumption boost.** The general expectation is that the RMB's increased usage as a reserve currency would be accompanied by a rise in its value over the long term. If correct, this would help boost Chinese consumption by lowering import costs, as well as help improve consumer finance. In this regard, timing could be particularly beneficial if it supports the incremental rebalancing of the Chinese economy toward consumption.
- **Geopolitical prestige and influence.** A large part of China's motivation to ensure SDR inclusion of the RMB this year is for political prestige. Official designation and unofficial recognition of the country's currency carries large symbolic weight. It denotes China's rise as a global power and is testimony to its economic success. In addition to prestige, it could also increase China's influence, particularly in Asia, as close trading partners may choose to peg their currencies to the RMB. Reserve status promotes regional economic integration and also enhances China's ability to provide financial support, complementing its political, economic and military status as Asia's leading power.

Potential Costs for China

Balanced against these very substantial benefits, there are costs to being a reserve currency. These include:

- **Exchange rate appreciation, leading to a decline in export competitiveness.** By definition, a reserve currency is one that both public and private agents want to hold. As current reserve currencies float, this demand pressure can lead to an exchange rate level that it otherwise would not obtain. A country's exports become less competitive, and resources may be directed to the non-tradable sector. The US, for example, has run large trade deficits for many years.
- **Exchange rate volatility, which may complicate the conduct of monetary policy.** If a currency serves as a "safe haven" currency, it can at times overshoot to the upside, thereby depressing domestic economic activity. Conversely, if the monetary authorities of a reserve currency are deemed to be running inflationary monetary policies, the currency can overshoot to the downside, thereby exacerbating inflationary tendencies.

- **Greater responsibility for international monetary arrangements.** As one's currency becomes more and more used internationally, the impact of domestic monetary policy decisions increasingly impacts the rest of the world, which may be in different phases of the business or credit cycle. This development could make other economies vulnerable to a tightening cycle by the reserve currency hegemon. For example, one of the causes of the Latin American debt crisis of the early 1980's was the sharp rise in US interest rates brought about by the Volcker disinflation program. Several Latin American countries defaulted on their dollar debt and suffered a "lost decade" of high unemployment and lost output. The United States was obligated to provide emergency financing to many Latin countries, and to lead international "bail out" and debt relief programs.
- **A modest loss of autonomy in the conduct of monetary policy.** Domestic considerations substantially dwarf international considerations in the conduct of monetary policy, but negative spillovers from the monetary policies of countries with reserve currencies to the rest of the world can complicate international relations in other spheres — for example, national security.
- **Less fiscal discipline which, over time, can lead to excessive levels of debt.** No political system is immune from moral hazard arising from favourable funding conditions, potentially exacerbating future fiscal problems.

Conclusion

China's renminbi currently accounts for roughly 1% of global foreign exchange reserves. And foreigners currently own only 3% of its government bond market. (By contrast, foreigners hold about 60% of US debt held by the public). Absent a major policy mistake, this percentage can be expected to grow. The pace at which the RMB becomes a significant reserve currency depends on the reforms that China undertakes and, more importantly, the perceptions of both official and private agents of the soundness, coherence and viability of those reforms and of China's macroeconomic and political choices. The drive by China to become a significant reserve currency should be seen as part of its overall international economic policy, including the establishment of new institutions, such as the Asia Infrastructure Investment Bank.

This article has outlined some of the major benefits and costs to China's quest for reserve currency status. Historically, the international monetary system has operated on the basis of multiple reserve currencies. Given the scale of challenges ahead, it would be another remarkable feat if the renminbi achieved reserve currency status in the gradual manner that has characterized China's development of the past 30 years. In this regard, we can perhaps look to another parallel: the Chinese authorities may hope to use the requirements that global investors demand of a reserve currency to modernize its financial sector. It employed the same logic when it used WTO accession in 2001 to restructure its industrial sector. RMB inclusion in the SDR is a very small step in China's quest for major reserve currency status. But as Lao Tzu observed around 500 BC, "The journey of a thousand miles begins with a single step."

[1] All figures calculated from the IMF World Economic Outlook Database.

[2] Obstfeld, Maurice "The SDR as an International Reserve Asset: What Future?" London School of Economics — International Growth Centre, Rapid Response March 2011, p.4.

[3] Goldberg, Linda, Mark Choi and Hunter Clark. "What if the US Dollar's Global Role Changed?" Liberty Street Blog, 3 October 2011 and McKinsey Global Institute "An Exorbitant Privilege? Implications of Reserve Currencies for Competitiveness", December 2009, p. 8.

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