



## Analysis of the RMB's Chance to be Included in the SDR

Dai Daohua, Senior Economist

The International Monetary Fund (IMF) will unofficially begin its quintuple review of the SDR basket this May, with official result to be expected in October, and implementation at the beginning of 2016. Taking into account of the progress made in China's financial reforms and the RMB's internationalization in the past several years, the market is generally optimistic about the RMB's chance to make it into the SDR basket this time around. However, the RMB will have to qualify as a freely usable currency as defined by the IMF, and overcome the possible veto of the US. The former requirement is attainable, with uncertainties presented by the latter. Given that the US Congress has stalled in authorizing the US Government to participate in the IMF reforms in the past several years, it remains a formidable obstacle.

### Requirements

In 2010 when the IMF reviewed the SDR currencies basket, it took great pains to examine and analyze whether the RMB met its requirements, and the RMB was the only currency being seriously considered at the time. To qualify, a currency has to meet two criteria, the first being that its exports of goods and services during the five-year period ending 12 months before the effective date of the revision have the largest value. As the SDR contained four currencies, the US dollar, the Euro, the British Pound, and the Yen, it implies that China's goods and services exports would have to surpass those of the United Kingdom and/or Japan. China met this criterion in 2010, as it was the world's third largest exporter of goods and services at that time. The second criterion is that it has to be determined by the IMF under Article XXX (f) to be a freely usable (FU) currency. In 2010, the IMF concluded that the RMB had not met this requirement, and thus decided to maintain status quo.

It is worth noticing that IMF, in its own report, clearly states that the concept of a freely usable currency concerns the actual international use and trading of currencies, and is distinct from whether a currency is either freely floating or fully convertible. In other words, the facts that the RMB is not yet fully convertible, China still imposes capital controls, and the related RMB exchange rate mechanism shall not be considered obstacles to the RMB's path into the SDR. To determine whether a currency is widely used for international payments or widely traded, IMF referred to four quantitative indicators.

The first indicator was the Currency Composition of Official Foreign Exchange Reserves (COFER) compiled by the IMF itself. The statistics show that the four SDR currencies accounted for 96.1% of allocated forex reserves in the world in 2010. The RMB was not tallied individually, becoming part of other currencies that had a share of 3.8% of the total. The second indicator was the international banking liabilities compiled by the Bank of International Settlements (BIS). It shows that in the previous five years, the four SDR currencies accounted for 91.7% of the total. Again, the RMB was not separately accounted for, becoming part of other currencies that had a share of 7.3% in 2009. The third indicator was the international debt securities statistics also compiled by BIS. It shows that the four

SDR currencies accounted for 94.6% of the total in the previous five years, while the RMB's share being only 0.06% (2009), lower than those of Swiss Franc, Australian dollar, and Canadian dollar who all had shares of more than 1%. The fourth indicator being used was global forex markets turnovers captured by BIS' Triennial Central Bank Survey. It shows that the four SDR currencies accounted for 77.6% of the total from 2007 to 2010, while the RMB's share being 0.1%, again lower than those of Swiss Franc, Australian dollar, Canadian dollar, Hong Kong dollar, and Swedish Krona who all had shares of more than 1%.

These criteria were first put to use in 2000, making its history short at ten years and three SDR reviews. In-between, the RMB's internationalization had made progress such as central banks holdings, trade settlements, offshore markets developments, etc. And China had also made headways in capital account liberalization and capital controls relaxation. It is just that the progress had yet to meet the freely usable criterion. But how about now?

### **Basic requirements met**

If the IMF in this year continues to use the same criteria as in last review in 2010, the RMB stands a much better chance to meet the requirements. Firstly, in terms of exports, China has become the world's largest goods exporter and fifth largest services exporter. Put together, it is the world's third largest goods and services exporter, second to only the European Union and the US. Secondly, according to SWIFT, the RMB has become the second most used currency in trade finance, and the fifth largest currency in payments, positioning right behind the four SDR currencies.

Next, let's see how well the RMB does in the four categories referred to by the IMF. So far, COFER has not been able to single out the RMB in its statistics. Judging from the fact that when COFER began to report the Canadian dollar and Australian dollar individually in 2013, they accounted for about 1.5% each of the world's allocated forex reserves holdings, the RMB has yet to reach such a threshold. It was included in other currencies that accounted for 3.2% of the total in 3Q14. But there is good reason to believe such a threshold could be quickly reached considering there are reportedly more than 40 central banks around the world who have already or planned to hold RMB assets in their forex reserves. They can add to the exposure through offshore markets, QFII, RQFII and China's interbank bond market. With regard to the latter, so far there are more than 20 central banks including Switzerland, France, Japan, Austria, Australia, and Singapore, etc., who are granted quota for China's interbank bond market investment.

In BIS' international banking liabilities statistics, the RMB is not yet identified individually either. Since the data series refer to offshore deposits, based on China's own releases, offshore RMB deposits at the end of 2014 amounted to RMB2.8 trillion, with RMB1.2 trillion found in Hong Kong's banking system (including CDs). Using the prevailing exchange rate of 1 US dollar for RMB6.20, it equaled to about USD440 billion, making it the fifth largest currency right behind the four SDR currencies. In terms of global forex trading turnover statistics from BIS, the RMB is ranked the ninth with a share of 2.2/200. Its weakness lies in international debt securities market. Now that BIS does not list RMB individually, cross comparison using the offshore RMB bond market's size of RMB480 billion results in a small share of 0.4% of the total.

Overall, the RMB's strength lies in exports, trade finance and payment, and it is gaining significantly in terms of offshore deposits and forex trading. Its weakness is in central banks holdings and the RMB international bond market. Regarding central banks holdings, it is reciprocal with whether the RMB makes it into the SDR, which IMF should take into account because failure to grant the RMB the international reserve currency status through SDR inclusion may impede investment decisions by some conservative central banks. On the other hand, both the onshore and offshore RMB bond markets have continued to register rapid growth. Moreover, those indicators are not meant to be used mechanically. IMF also emphasizes that the Executive Board's judgment is necessary. Combined with Christine Lagarde's latest comment that it is a matter of when, not if, the RMB makes it into the SDR, and the RMB internationalization's progress in the past several years, the RMB stands a fairly good chance to pass IMF's internal assessment of being freely usable in this year's review.

However, it is worth noticing that in 2011, IMF was mulling new reserve asset criteria instead of freely usable criteria to decide whether to add a currency into the SDR basket. The proposed new criteria supposedly make it easier to expand the SDR basket, and it uses four indicators, volume of transactions in forex spot markets, volume of transactions in forex derivatives markets and OTC derivatives trade, existence of an appropriate market-based interest rate instrument, and COFER. Two of these indicators differ from the old ones. The IMF ran scenario analysis, whose results suggested that in order for the RMB to meet the requirements by 2015, it would have to grow much faster in different market segments. And by 2015, the Canadian dollar and Australia dollar would rank ahead of the RMB in many markets, suggesting they might be added to the SDR basket ahead of the RMB. Therefore, the proposed new criteria may not be the most beneficial to the RMB. But it is unclear whether the IMF will use the new criteria or stick to the old ones in this year's review.

## **The US veto**

Other than the freely usable requirement, the RMB's SDR prospect will also hinge upon the US Government and the US Congress's stances, with the former being more prone to be won over than the latter.

Currently, the IMF's decisions have three thresholds. Decisions requiring a 50% majority of the votes cast include those pertaining to the Fund's daily function such as approval of specific lending programs. Special majorities of 70% of total voting power are required for decisions that fundamentally alter the IMF's operational practices such as the design of IMF facilities, changes to the interest rates on IMF loans/SDR, the budget of the IMF, etc. The 85% threshold applies mainly to decisions on the Fund's governance structure such as amending the IMF's Article of Agreement, changing the number of Executive Directors, new membership, quota increase, reallocation of SDR, etc. The US currently has a voting share of 16.75%, meaning it has the veto power on the most important IMF decisions. As the inclusion of the RMB into the SDR basket will trigger many rules changes of the SDR, it is believed to need 85% of voting shares, making the US decision critical.

Under separation of power, the US President has the authority to appoint the US Governor, Alternate Governor, Executive Director, and Alternate Executive Director to the IMF. The Department of the Treasury has been delegated responsibility to direct US representatives at the IMF and to take a range of actions with respect to the IMF. The Secretary of Treasury, as a matter of practice, is nominated to serve as the US Governor at the IMF, while the Chairman

of the Federal Reserve as the Alternate US Governor. According to the US Law, the US Congress is responsible for authorizing and appropriating all US financial commitments to the IMF, including the US quota and voting share, etc.

In the IMF's 2010 review, the RMB was considered not meeting the freely usable criteria in the internal assessment stage. Thus, the IMF proposed no change to the SDR basket, without triggering the US veto decision. Later this year when the IMF revisits the issue, if the RMB passes the initial internal assessment, then voting is required and the possible US veto will matter. At the end of March of this year when the US Treasury Secretary Jacob Lew visited China before the Sino US Strategic Dialogue at yearend, China's Premier Li urged the US to support the RMB's inclusion into the SDR. Shortly after the meeting, the US Treasury Secretary returned home and gave a speech at a function in San Francisco, reiterating the stance that China needed to further relax capital controls, liberalize interest rates and let the market play a pivotal role in deciding the exchange rate before the RMB is eligible for the SDR. The tone was harsh. But considering the Chinese Government's commitment in its Working Report to push for the RMB's convertibility under capital counts, the launch of deposit insurance scheme in May, etc., it is believed that more reform and open measures will be introduced before the IMF's review at yearend, paving the way for a favorable decision.

Nevertheless, in the case that the US Government goes with the IMF proposal to add the RMB to the SDR, it has to obtain the authorization from the US Congress to be effective. In this regard, it remains quite a challenge. During the Treasury Secretary's visit in March, he was also urged by the Chinese Premier to support the IMF reform initiatives of 2011. They include doubling the IMF quota, transferring 6% of the expanded quota to emerging markets, selecting all Executive Directors by election, not by appointment in some cases, and transferring two Executive Directors posts from Europe to emerging markets. The reforms will make China the third largest shareholders of the IMF, and make all BRIC countries into top ten shareholders. Moreover, China's voting share will increase from 3.81% to 6.0%, while the US' declining slightly from 16.75% to 16.5%, but still maintaining its veto power. These reforms are also the consensus of G20, which the US Government supports. However, according to the US Law, it needs the US Congress' authorization, which it has failed to grant in all these years, exposing the rift between the administrative and legislative arms of the US to the dissatisfaction of even the US allies. Judging from this example, it is not unreasonable to speculate that the US Congress might block the RMB's inclusion into the SDR even though the US Government gives the green light, which is essentially the same as the US casting its veto.

### **Possible consequences**

However, such a scenario may have limited impacts. At the current stage, the SDR inclusion will grant the RMB the international reserve currency status, which will help propel its internationalization. Even if the US Congress stands in the way, it will be reduced to technical obstacle given that the IMF, most of its members, and even the US Government give their blessings. It will do little harm to the RMB's international reserve currency status, as China's reform efforts are for all to see. It is thus believed that investment in RMB assets will be little affected. The next IMF review will be five years away at 2020. By then the RMB's internationalization and China's financial opening are likely to surpass the SDR requirements by wide margins. The SDR recognition will be long overdue. Hence, the 2015 review is also a window of opportunity for the IMF, failing to capture which will in turn hurt the SDR's credibility.



# 主要經濟指標 (Key Economic Indicators)

| 一. 本地生產總值 GDP                                | 2013   | 2014   | 2014/Q3         | 2014/Q4         |
|----------------------------------------------|--------|--------|-----------------|-----------------|
| 總量 (億元) GDP(\$100 Million)                   | 20,961 | 21,446 | 5,456           | 5,733           |
| 升幅 (%) Change(%)                             | 2.9    | 2.3    | 2.7             | 2.2             |
| 二. 對外貿易 External Trade                       | 2013   | 2014   | 2015/2          | 2015/1-2        |
| 外貿總值 (億元) Total trade(\$100 Million)         |        |        |                 |                 |
| 港產品出口 Domestic exports                       | 544    | 553    | 29              | 74              |
| 轉口 Re-exports                                | 35,053 | 36,175 | 2,254           | 5,327           |
| 總出口 Total exports                            | 35,597 | 36,728 | 2,283           | 5,401           |
| 進口 Total imports                             | 40,607 | 42,190 | 2,642           | 6,127           |
| 貿易差額 Trade balance                           | -5,010 | -5,463 | -359            | -726            |
| 年增長率 (%) YOY Growth(%)                       |        |        |                 |                 |
| 港產品出口 Domestic exports                       | -7.6   | 1.7    | -10.9           | -2.5            |
| 轉口 Re-exports                                | 3.8    | 3.2    | 7.5             | 4.7             |
| 總出口 Total exports                            | 3.6    | 3.2    | 7.2             | 4.6             |
| 進口 Imports                                   | 3.8    | 3.9    | -0.9            | 3.9             |
| 三. 消費物價 Consumer Price                       |        |        |                 |                 |
| 綜合消費物價升幅 (%) Change in Composite CPI(%)      | 4.3    | 4.4    | 4.6             | 4.3             |
| 四. 樓宇買賣 Sale & Purchase of Building Units    |        |        | 2015/3          | 2015/1-3        |
| 合約宗數 (宗) No. of agreements                   | 70,503 | 81,489 | 6,211           | 22,581          |
| 年升幅 (%) Change(%)                            | -29.9  | 15.6   | 48.4            | 61.4            |
| 五. 勞動就業 Employment                           |        |        | 2014/11-2015/01 | 2014/12-2015/02 |
| 失業人數 (萬人) Unemployed(ten thousands)          | 11.84  | 14.95  | 12.1            | 12.2            |
| 失業率 (%) Unemployment rate(%)                 | 3.4    | 3.2    | 3.3             | 3.3             |
| 就業不足率 (%) Underemployment rate(%)            | 1.5    | 1.5    | 1.6             | 1.5             |
| 六. 零售市場 Retail Market                        |        |        | 2015/2          | 2015/1-2        |
| 零售額升幅 (%) Change in value of total sales(%)  | 11.0   | -0.2   | 14.9            | -2.0            |
| 零售量升幅 (%) Change in volume of total sales(%) | 10.6   | 0.6    | 18.2            | -0.3            |
| 七. 訪港遊客 Visitors                             |        |        |                 |                 |
| 總人數 (萬人次) arrivals (ten thousands)           | 5,430  | 6,077  | 541             | 1,102           |
| 年升幅 (%) Change(%)                            | 11.7   | 11.9   | 22.4            | 11.6            |
| 八. 金融市場 Financial Market                     |        |        | 2015/1          | 2015/2          |
| 港幣匯價 (US\$100=HK\$)                          | 775.4  | 775.6  | 775.3           | 775.4           |
| H.K. Dollar Exchange Rate (US\$100 = HK\$)   |        |        |                 |                 |
| 貨幣供應量升幅 (%) change in Money Supply(%)        |        |        |                 |                 |
| M1                                           | 9.7    | 13     | 18.3            | 4.2             |
| M2                                           | 12.3   | 9.5    | 10.3            | 8.3             |
| M3                                           | 12.4   | 9.6    | 10.4            | 8.3             |
| 存款升幅 (%) Change in deposits(%)               |        |        |                 |                 |
| 總存款 Total deposits                           | 10.6   | 9.7    | 10.9            | 8.8             |
| 港元存款 In HK\$                                 | 5.1    | 9.3    | 11.4            | 6.3             |
| 外幣存款 In foreign currency                     | 16.2   | 10.1   | 10.5            | 11.2            |
| 放款升幅 (%) in loans & advances(%)              |        |        |                 |                 |
| 總放款 Total loans & advances                   | 16.0   | 12.7   | 10.0            | 6.6             |
| 當地放款 use in HK                               | 13.8   | 12.1   | 9.3             | 4.3             |
| 海外放款 use outside HK                          | 21.4   | 14.2   | 11.6            | 12.1            |
| 貿易有關放款 Trade financing                       | 43.8   | -1.4   | 2.3             | -6.7            |
| 最優惠貸款利率 (%) Best lending rate (%)            | 5.0000 | 5.0000 | 5.0000          | 5.0000          |
| 恆生指數 Hang Seng index                         | 23,306 | 23,605 | 24,507          | 24,823          |