The Economist

The yuan and the SDR

Feeling special

The IMF debates whether to include China's currency in its reserves

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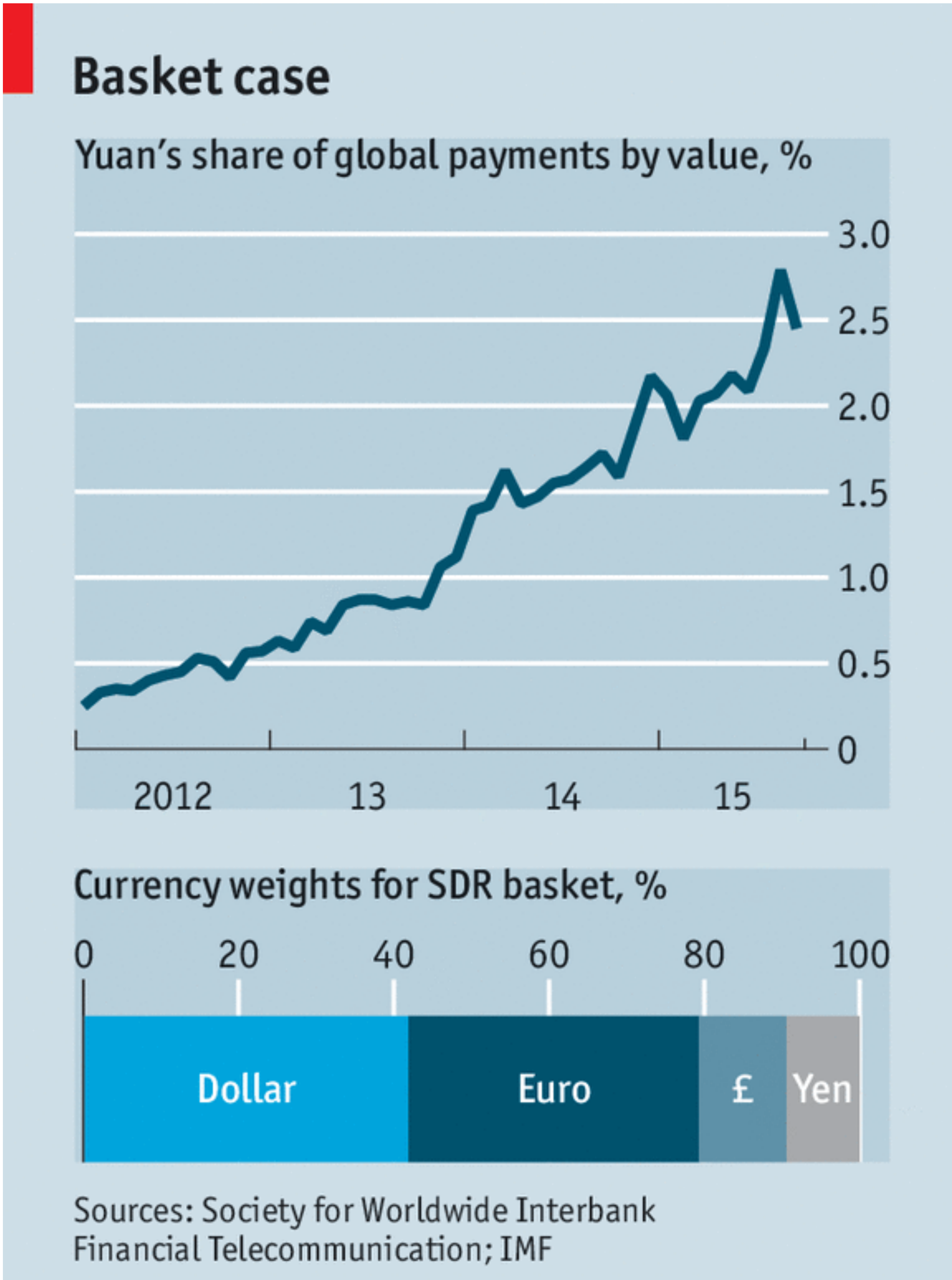
THE summer of 1969 is remembered for many things: the moon landing, Woodstock and the start of American troop withdrawals from Vietnam. The International Monetary Fund's creation of the Special Drawing Right (SDR) does not rank high on this list. An artificial accounting unit, the SDR resides on the margins of the global financial system. But over the next few weeks, China will haul it into the spotlight.

The question is whether the IMF will include the yuan in the basket of currencies of which the SDR is composed. Its decision, part of a five-yearly review, is expected at the end of the month. Since the late 1990s the SDR has comprised four currencies: the dollar, the euro, the pound and the yen. The IMF allocates some of its notional stash of SDRs to its members, which can be swapped in a pinch for their constituent parts to make external payments.

Adding the yuan to the basket would give it the IMF's imprimatur as a reserve currency: easily tradable and a good store of wealth. This does not mean it would suddenly rival the dollar. The outstanding value of SDRs is just over $300 billion, about 2.5% of global currency reserves. The yuan would only form a small portion, and it is rare for countries to make payments in SDRs.

The symbolism would nonetheless be powerful. Central banks might feel more comfortable holding yuan, as would institutional investors. Standard Chartered, a bank, estimates an extra $1 trillion will be allocated to Chinese assets in the coming five years if the IMF brings the yuan into the SDR.

That the yuan even qualifies for consideration might seem surprising. The People's Bank of China (PBOC) has a big hand in determining its value and the yuan is not freely convertible. China limits how much money its citizens can send abroad and foreigners can bring in. But convertibility is not a prerequisite for SDR status. As IMF staff explained in a report in August, there are only two criteria: the issuing country must be a big exporter and its currency widely used.



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China, the world's biggest exporter since 2009, obviously satisfies the first criterion. The second, however, is woollier. The yuan is not as widely used as the other SDR currencies. In 2014 it ranked seventh in countries' official reserves, eighth in international bond issuance and eleventh in global currency trading. Yet its trajectory is impressive: SWIFT, a global transfer system, calculates it has gone from the 20th most-used currency for cross-border payments at the start of 2012 to fifth today.

Elevating the yuan might serve two ulterior purposes for the IMF. First, the PBOC has been the strongest proponent of financial reform in China, and bringing the yuan into the SDR would strengthen its authority and spur it to do more. In the past three months, to prepare the yuan for the SDR, the PBOC has opened the Chinese bond market to foreign central banks and changed the way the yuan is managed, giving the market more influence. These are important steps towards opening the capital account. Rejection from the SDR would risk undermining China's financial reforms, at a time when other efforts, notably in overhauling state-owned monopolies, are sputtering.

Second, bringing the yuan into the SDR is as significant for the IMF as for China. Reforms to give emerging markets more voting power have been held up for years by America's dysfunctional politics, and in any case do not go far enough. The SDR would be a consolation prize for the world's biggest emerging market. "The IMF needs this to go forward so that it maintains legitimacy," says Eswar Prasad of Cornell University.

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