FINANCIAL TIMES

May 5, 2015 5:56 am

China knocks on door of reserve currency club

Gabriel Wildau in Shanghai

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The internationalisation of China's renminbi faces its stiffest test yet as the International Monetary Fund debates whether to endorse the "redback" as a reserve currency alongside the dollar, euro, yen and sterling.

Becoming a constituent in the IMF's Special Drawing Rights basket would be a big step forward for the currency, which remains tightly controlled by Beijing. Economist Louis Gave of GaveKal Dragonomics likens the move to Japan's currency liberalisation in the 1980s and the subsequent run-up in yen assets.

"Very quickly, global equity and bond investors were chasing their own tails, pushing up the value of the yen together with Japanese equity and bond valuations to regular new highs." (From which, of course, they subsequently retreated as the bubble imploded.)

However, the rewards for Beijing would be more than simply financial: acquiring SDR rights would be a powerful boost to its geopolitical ambitions.

"For China, SDR basket inclusion is symbolic to global recognition of its rise in status," Paul Mackel, head of Asia forex research at HSBC, wrote in a recent report. "The very stringent requirements for currency inclusion in the SDR serve as a quality assurance to global users that the currency in question is indeed very liquid and stable as a store of value."

That will feed into the IMF's deliberations. "The crux of the matter is that this is ultimately going to be decided on political rather than economic merits," says Eswar Prasad, economics professor at Cornell University and former China country director for the IMF.

China's bid for more influence in the international monetary system began at the peak of the global financial crisis in March 2009, when central bank governor Zhou Xiaochuan published a paper in English titled "Reform the international monetary system".

Mr Zhou argued that the global financial crisis had exposed the vulnerabilities of over-reliance on the dollar, and proposed beefing up the SDR so it could serve as "an international reserve currency that is disconnected from individual nations".

In March this year Chinese Premier Li Keqiang told IMF managing director Christine Lagarde that China intended to accelerate reforms needed to meet the criteria for SDR inclusion.

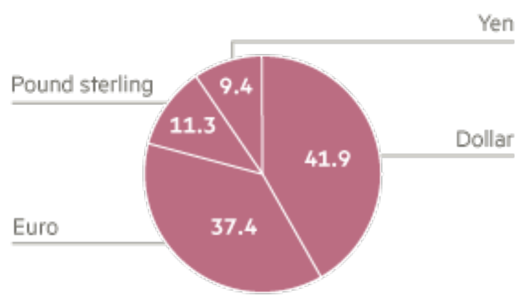
The IMF board will vote in November or December. Before that, a staff review this month will assess the renminbi's suitability based on four criteria.

The first three — transaction volume in foreign exchange spot markets; transaction volume in forex derivatives markets; and use of the currency by central banks as reserves — are partly subjective, says Mr Prasad. So long as the renminbi is widely used, the IMF could determine that the criteria have been met, even if the renminbi ranks even lower than other non-SDR currencies on one or more measure.

The fourth hurdle, which essentially requires a yes or no decision on whether renminbi interest rates are market-based, will be much harder to clear.

Special Drawing Rights basket

Per cent



Source: IMF

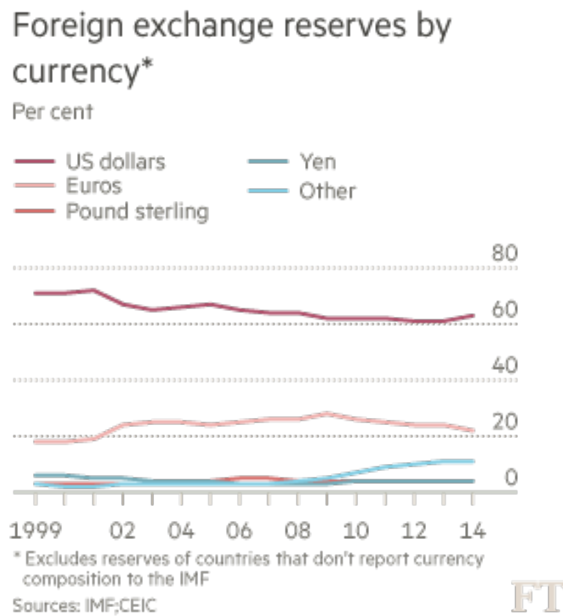
Mr Zhou said in March that China may eliminate the administrative cap on bank deposit rates — the last interest rate in China subject to government control — by the end of this year. That might provide the opening IMF board members need to admit China into the SDR club.

But the US is likely to push back by urging the IMF to interpret its rules strictly and arguing for the SDR to be used as an incentive to press for greater financial liberalisation.

Mr Zhou's statement leaves ample flexibility to delay freeing up deposit rates if economic conditions change — a scenario that looks increasingly plausible.

China has cut benchmark interest rates twice since November in a bid to reduce financing costs for businesses amid a slowing economy. Removing the deposit-rate cap would probably have the opposite effect, pushing rates higher as banks compete for funds.

"We believe that the RMB's inclusion in the SDR (and indeed RMB internationalisation itself) is being used mainly as a goalpost, to catalyse domestic financial sector reforms, especially interest rate liberalisation and China's capital account opening," Tao Wang, UBS China economist, wrote recently.



The fund has already signalled its approval of recent reforms to loosen the government's tight grip on the currency. Markus Rodlauer, deputy director of the IMF's Asia-Pacific department, said during Ms Lagarde's visit that the renminbi exchange rate was "moving toward equilibrium", a shift in tone from the fund's longstanding assessment that the exchange rate is "undervalued".

IMF rules require a review of the SDR basket at least every five years but more frequent reviews are permitted. That leaves open the possibility of a compromise in which the IMF decides the renminbi is close to meeting the relevant criteria but still falls short, and schedules another review sooner than 2020.

However, such a move would not be without risk.

"It will be seen as a slap in Beijing's face if the IMF chooses to punt on this issue now," says Mr Prasad. "That would really poison the relationship between the IMF and China."

Twitter: @gabewildau

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