Can Chinese Yuan Become A Major Reserve Currency?

Congsheng Wu
Ernest C. Trefz School of Business
University of Bridgeport, Bridgeport, CT

Introduction

After several years of efforts, especially on the part of the Chinese government, the International Monetary Fund (IMF) announced on November 30, 2015 that the Chinese currency, yuan (RMB or人民币), will be included into the Special Drawing Right (SDR) basket, starting in October 2016. The SDR is an artificial currency created in 1969 to implement the U.S. dollar as an reserve asset. The SDR has been used as the unit of account in IMF. Currently, the SDR consists of four currencies: $, €, £, and ¥. These four currencies are also the major reserve currencies held by the central banks.
Two questions arise:
(1)Is the RMB ready to be a major reserve currency?
(2)What are the benefits and costs of being a reserve currency?

Currently, the SDR basket comprises four currencies: Euro, Japanese yen, Pound sterling, and U.S dollar. The weight of each currency has been fixed in the past five years, but will be revised in October this year, when the Chinese yuan is added to the basket. The value of the SDR depends on the exchange rates.

SDR rates as of: March 16 2016 Go

Wednesday, March 16, 2016

Currency	Currency amount under Rule O-1	Exchange rate [1]	U.S. dollar equivalent	Percent change in exchange rate against U.S. dollar from previous calculation
Euro	0.4230	1.10900	0.469107	-0.063
Japanese yen	12.1000	113.51000	0.106599	-0.529
Pound sterling	0.1110	1.40970	0.156477	-0.445
U.S. dollar	0.6600	1.00000	0.660000	
			1.392183	
		U.S.$1.00 = SDR	0.718296 [2]	0.112 [3]
		SDR1 = US$	1.392180 [4]	

Does Chinese yuan meet the criteria for SDR basket inclusion?
The IMF has two criteria:

(1) The export criterion: This criterion acts as a "gateway" and aims to ensure that currencies that qualify for the basket are those issued by members or currency unions that play a central role in the global economy. This criterion has been part of the SDR methodology for a long time. China easily meets this standard.

(2) The freely usable criterion: The requirement for currencies in the SDR basket to be also freely usable is the second criterion that was incorporated in 2000 to formally reflect the importance of financial transactions for the purposes of valuing the SDR basket. A "freely usable" currency is defined in the IMF's Articles of Agreement to mean a currency that the IMF determines (i) is in fact widely used to make payments for international transactions, and (ii) is widely traded in the principal exchange markets. 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. A currency can be widely used and widely traded even if it is subject to some capital account restrictions. On the other hand, a currency that is fully convertible is not necessarily widely used and widely traded.

Major reserve currencies: Past and Present

Pound sterling was the preeminent global reserve currency prior to 1914

- Britain was the world's preeminent trading nation, absorbing more than 30 percent of the exports of the rest of the world in 1860 and 20 percent in 1890.
- Between 1860 and 1914 probably about 60 percent of world trade was invoiced and settled in sterling.
- London's financial markets were well developed. Foreign governments seeking to borrow abroad came to London, making sterling the logical unit of account for debt securities.

Ascending of the U.S. Dollar

- U.S. surpassed U.K. to become the largest economy in the world in 1879.
- In trade, U.S. first caught up with the U.K. during the First World War. U.S. exports grew faster than those of any other nation in the decades leading up to World War I. By 1912, the United States was the leading trading nation. However, virtually no trade credit was provided by U.S. banks or denominated in dollars.
- It is often said that the international reserve currency status was subject to much inertia. The pound sterling continued to be the global reserve currency even after the U.S. economy became No. 1. But the pattern is that the dollar was on the rise while the pound faded away.
- The status of the U.S. dollar as a dominating reserve currency was finally established in 1944 when the Bretton Woods agreement was signed.
- Today (as of 2015 Q2), the dollar accounts for about 64% of global reserves.

Will Chinese yuan be the next one?

Pros and cons of being a reserve currency: The case of the U.S. dollar

Benefits:

1. **Seigniorage:** In the 1960s, France's finance minister argued that the United States enjoyed an "**exorbitant privilege**" because the dollar was the global reserve currency. This privilege acts like interest-free loans generated by issuing additional currency to nonresidents who hold US notes and coins. It's estimated that roughly half of U.S. currency (about $800 billion) are held by foreigners.
2. **Reduced interest rates:** Foreign purchases of U.S. financial assets drive dollar interest rates lower. Reduced interest rate will benefit U.S. borrowers, including the government, companies, and households who are able to raise capital more cheaply.
3. **Strong currency will benefit consumers:** Foreign purchases of dollar assets will make the dollar stronger; And a strong dollar is good for U.S. consumers.

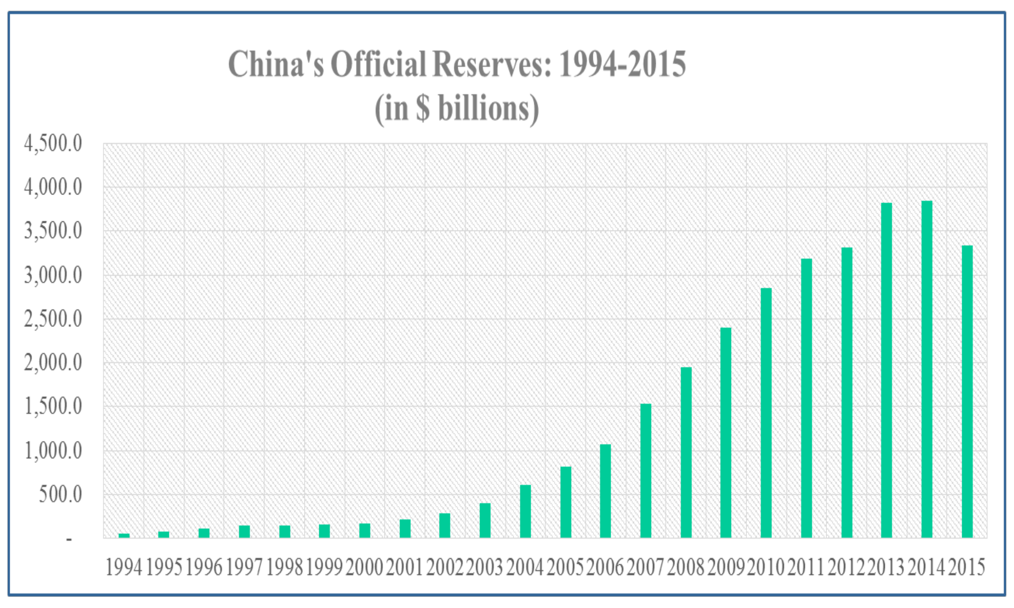
Costs: Who will lose?

1. **Exporters and sectors competing with foreign imports:** A strong currency will hurt the competitiveness of the country's exporting companies and companies that compete with imports
2**. Savers and fixed income investors:** Both will hurt due to reduced interest rates.

Overall, the benefits exceed the costs. According to a study by the McKinsey Global Institute, the benefits add up to $100 billion for America in a normal year while the cost is about $30-60 billion, leading to a net benefit: $40 to $70 billion or 0.30-0.50% of GDP.
.

Policy Implications for China

That yuan will join in the SDR basket soon doesn't immediately mean that it will become a major reserve currency. From the perspective of diversification, central banks around the world should hold some yuan assets since China is one of the major emerging markets. Further more, given the gargantuan size of China's official reserves (see below), the yuan can also be an attractive asset to hold. However, the willingness by central banks to hold yuan as a reserve asset will be affected by a number of factors:
1. Size of economy
2. Open capital account
3. Flexible exchange rate
4. Financial market developments
The key is free convertibility of yuan and high capital mobility. However, in choosing a currency regime (fixed, managed, or floating), Chinese policy makers will inevitably face the so-called Impossible Trinity (or trilemma), which states that among the three desirable features--that is, exchange rate stability, high capital mobility, and monetary independence, only two can be achieved simultaneously, regardless of the currency regime.



Yuan vs Dollar Rivalry?

Not in the near future; but in the long run, it's quite likely.