Evaluating Yuan Inclusion in the IMF Special Drawing Rights Basket

Yucheng Lu*

Abstract: After the IMF's recent review on its Special Drawing Rights (SDR), the Chinese Yuan (RMB) became the fifth currency to join the SDR currency basket. The RMB has seen an increase in use in global trade, although many, including opportunistic politicians, criticize China's manipulation of currency markets. This article analyzes the validity of the IMF decision according to the organization's SDR currency selection criteria and discusses the potential ethical problems of the decision.

Introduction

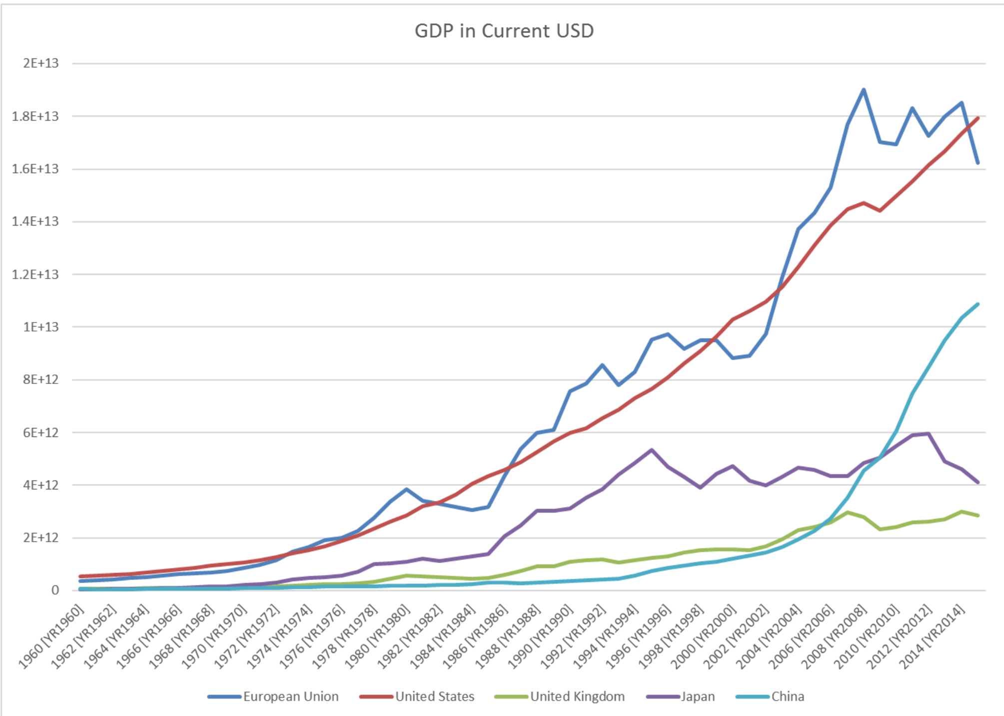
In its 2015 November meeting, the International Monetary Fund approved the inclusion of the Chinese Renminbi Yuan (RMB) in the International Monetary Fund (IMF) Special Drawing Rights (SDR) currency basket, despite China's long history of capital controls. The SDR is "not a currency, nor a claim on the IMF, but is potentially a claim on freely usable currencies of IMF members." (IMF) The IMF's decision gives countries some confidence in holding RMB as part of their foreign reserves. (Economist) Eventually, the RMB will play a greater role in global markets and the world will have an alternative reserve currency. Some dispute the potential benefits of the inclusion of RMB, because of the belief that inclusion of a currency issued by an authoritarian government increases risk to the current international economic system. It therefore, is helpful to determine if the IMF decision is ethical.

This paper evaluates the IMF's decision from an ethics perspective and describes the IMF's reasons for Yuan SDR inclusion. The paper finds the decision is ethical in terms of outcomes and intention.

* Mr. Yucheng Lu is pursuing his Masters in Economics at New York University.

Comparing China

China, a rapidly developing nation, is different politically and economically from other SDR currency issuers. From an economic perspective, the rest of the SDR countries are highly developed markets while China is not, even if it has achieved remarkable progress in economic growth in the course of 30 years. The country is still classified as an Upper Middle Income nation despite its economy expanding over 2400% since 1980. (World Bank) The impressive growth is a result of former president Deng Xiaoping's "Reform & Opening up" policies. The following chart demonstrates China's economy catching up with Western economies from 1960 to 2015.



(Data retrieved from World Bank World Development Indicators Database, in U.S. Dollar)

Although the current-price Gross Domestic Product (GDP) of the other 4 economies fluctuated in most of these years, Chinese data show relatively smooth and high economic growth. With its current economic expansion rate, the country will supplant the United States as the largest economy in the world. (Jacob)

A justification for the IMF's decision to include the RMB in the SDR basket is increasing economic interdependence between China and the rest of the world. The *Economist* released its innovative index of relative revenues earned in the Chinese market by some of the S&P 500 listed companies. The index has constantly outperformed the S&P 500 index, indicating a growing share of income of the big U.S. companies from China. (Economist) The inclusion of the RMB is thus partly based on the assumption China will be a leading contributor to the global economy.

Yet, there are grounds for concern given China's political system. Countries whose currencies are in the SDR basket before the recent SDR review are in large part, democratic and liberal nations. The United States, the European Union, the United Kingdom, and Japan are quite liberal democracies. These systems rely on democratically elected legislative bodies.

Under the governance of the Chinese Communist Party (CCP), China has been centralized in economic and political decision making, with an authoritarian government exercising power. For instance, the government does not allow dissenting views on its financial policies. Financial institutions, including securities companies and commercial banks, are required to follow the orders of financial regulatory bodies, even if such executive orders do not comport with any existing national laws. During the 2015 Chinese stock market crash, the Chinese government publically limited institutional investors' ability to short sell securities. (Xie, Spears, and Zhe) The government also made some investors pledge to go long in stocks. Several state-owned investors, informally called "Guo Jia Dui", helped the government stabilize prices of highly weighted index component stocks. (Hunter and Wong) Recently, the Chinese monetary regulators spoke to some commercial banks in cities short of private loans, demanding the local banks continue providing low-interest loans to small and medium-sized enterprises. These firms face higher costs of debts and would file for bankruptcy if not rescued by banks providing affordable loans. (Li) China's Prime Minister, Li Keqiang, also urged banks to support economic growth, encouraging them to "roll over loans when needed". (Qi)

Internationally, the Chinese government has been criticized for subsidizing export-oriented industries. Recently, the United States imposed a higher anti-dumping tariff on the imports of Chinese cold rolled steel, raising the tax rate from 266% to 522%. The European Union and the United Kingdom also urged corresponding actions with regard to Chinese dumping policies, fearing China's subsidies would hurt their domestic industries. (Kollewe) In addition, China gives aid to rogue dictatorships, such as North Korea. The Chinese government "has historically opposed harsh international sanctions on North Korea in the hope of avoiding regime collapse and a refugee influx across their 870-mile border". (Council on Foreign Relations) China's financial aid to North Korea "doubled from $2.68 billion in 2009 to nearly $6.96 billion in 2014". (Gertz) These concerns give pause to the IMF's decision to add the RMB to the SDR basket.

Reasons for SDR Inclusion

The IMF reviews the composition of its SDR basket every 5 years. In 200 its Executive Board set the current criteria for SDR inclusion. The fundamental logic is to select currencies both issued by sovereignties heavily involved in global trade and "freely usable".

Since the 1970s, the IMF has adopted the export ("gateway") criterion, ensuring only countries playing by "central rules" in the global economy are considered for the SDR basket. This first criterion was once the sole criterion of SDR currency selection, and is assessed by using data released in countries' Balance of Payments. It then incorporated the "freely usable" criterion in 2000, such that the SDR basket reflects a currency's financial importance in global currency transactions. Specific guidance and 3 types of market observations, the existence of principal exchange markets, currency convertibility, and international transactions, contribute to the recognition of the "freely usable" feature of a currency. These criteria ensure SDR currencies' are stable and representative. (IMF)

The IMF initially rejected the inclusion of Chinese RMB in 2010, mostly due to its failure to fulfil the requirement of being "freely usable". (IMF) Although China played a significantly important role in international trade, its government has long been criticized for controlling the domestic RMB forex trading market. The Chinese RMB and other non-SDR currencies' "role(s) in the international monetary system lag far behind their real economic weight". ("Criteria for Broadening the SDR Currency Basket" 7) Before the 2015 review, the fund admitted RMB still "lag(ged) behind rivals on key metrics" (Wildau).

However, the fund, in its report on the 2015 review, says, "Across a range of indicators, the renminbi is now exhibiting a significant degree of international use and trading." (IMF 2015) The November 2015 meeting of the Executive Board determined the final inclusion of RMB in SDR basket. RMB serves as the fifth SDR currency, along with the U.S. dollar, Euro, Japanese Yen and British Pound Sterling. (IMF)

The IMF listed 3 main reasons to explain its decision. The RMB is qualified as a "freely usable" currency for the following reasons. First, RMB's scale of transactions in the global currency markets has been increasing significantly since the last IMF review in 2010, making it much more "widely used" and "widely traded". Second, the overall usage of RMB in global transactions can be conducted much more smoothly, thanks to China's commitments to conduct reforms in its financial policies, including the liberalization of Chinese domestic interest rates and the regulation of cross-border transactions. Third, the IMF has seen efforts in the enhancement of data disclosure from the Chinese authority, helping its currency meet transparency standards.

The Board also anticipated the future recognition and reinforcement of China's "continuing reform progress". The IMF confirmed its expectation of more stable economic growth and a more attractive SDR basket after the inclusion of RMB.

With the prevalence of RMB, the Chinese government would have more influence in the world economy, both positively and negatively. Before the inclusion of the RMB, SDR currencies were without exception, issued by countries with high levels of civil liberties. These nations, unlike China, have less control of their economies and better law enforcement systems in financial markets. This difference raises a concern about whether China, an important participant in international monetary markets, would abuse its power in the global economy.

Ethical Evaluation

By definition, the fundamental mission of the IMF is to "help ensure stability in the international system". "It does so in three ways: first, keeping track of the global economy and the economies of member countries (surveillance); second, lending to countries with balance of payments difficulties; and third, giving practical help to members." (IMF) The selection of SDR currencies, according to the description of its duties, lies in the monetary market surveillance section. The IMF is thus responsible for monitoring the global monetary market and ensuring its stability when reviewing the inclusion of RMB in the SDR basket.

From this point of view, the IMF should be judged by its efforts to fulfill its duties. The IMF had criteria for inclusion set before the 2015 final decision, and the Executive Board collected professional research reports from internal sources. "The Review of the Method of the Valuation of the SDR—Initial Considerations", prepared by IMF researchers, provided thorough considerations about future policy changes regarding the internationalization of RMB. This report, signed off by IMF staff, restates the high standards of the SDR currency basket "While a number of Directors were open to exploring alternative criteria, Directors stressed that the bar for inclusion should not be lowered." (IMF) The report also claims its key focus on evaluating RMB's being "freely usable", reaffirming the export ("gateway") criterion was met. It goes through "legal framework and interpretation of the freely usable concept" and discusses the updated "freely usable" indicators. The authors also test the validity of SDR currency selection criteria and address the potential operational issues related to RMB, as a SDR currency.

According to its guidance, the IMF does not exclude the inclusion of currencies issued by totalitarian governments, as long as they meet the criteria set to ensure the SDR currencies are representative and stable. The Fund also gave consideration to a wide range of operational risks associated with the inclusion of RMB. Although the Chinese government has attempted to influence the global economy by using its power in economic activities, there is no clear evidence China tried to intentionally destabilize its currency or enforce currency controlling rules. The Chinese monetary authority promised to deregulate its currency exchange rates and other financial instruments. (Xinhua) Therefore, the IMF fulfilled its obligations in the process of SDR currency selection.

The IMF's decision also can be evaluated by looking at its overall outcomes (or utility to the society). The inclusion of RMB offers a variety of benefits and costs to the globe.

China benefits from the internationalization of its currency. The inclusion makes RMB more widely used in international monetary markets, thus lowering Chinese financial institutions' borrowing costs. The internationalization of RMB boosts the overseas expansion of Chinese companies and financial institutions. In addition, it further improves China's economic and political position in the world and reduces the nation's "reliance on U.S. Dollars". (Zhang and Tao)

Costs also occur with SDR inclusion. China would lose its tight control on monetary policies, as a larger scale of international transactions may reduce the "effectiveness and independence" of the policies. The inclusion would also "reduce the autonomy of the country's exchange rate policy". Other costs include the loss of trade competitiveness and higher risks of financial instability. (Zhang and Tao)

Similarly, the rest of the world may experience positive consequences, thanks to the IMF's decision. According to Robert Mundell, a Nobel Laureate and IMF official, having the RMB in the SDR currency basket stabilizes the global financial system. (Chong and IMF) The inclusion also accelerates the liberalization of interest and exchange rates, as well as capital account transactions around the world. The RMB makes SDR reserves more attractive to countries, because of a higher level of diversity and representability after the inclusion. (IMF) For countries doing business with China, the inclusion lowers costs of transactions. African countries, such as Kenya, could save a large amount of money by directly converting between their local currencies and RMB. In the past, they needed to first convert the funds into U.S. Dollars. The USD acted as the intermediate currency in such activities, adding to transaction costs. With the internationalization of the RMB, African countries are likely to accept RMB as part of their foreign reserves. Ten percent of Nigeria's foreign reserves are in RMB. (Olingo)

The world, however, would have reasons to worry about the potential turmoil of the Chinese economy. As an emerging market, China has higher volatility in its economic growth outlook. Should there be a economic slowdown, its currency might fluctuate more than those of developed nations. This eventually results in systemic risks in global monetary markets. The controlling power of the Chinese government may be worrisome. To achieve its economic goals, the government may use its monetary policies to put pressure on foreign authorities.

Although there are potential costs, the more definite signs of benefits may surpass the possible negatives. The authoritarian government of China does not have the express intention to cause economic harm, while its commitments to liberalize its monetary market further enhances the probabilities of positive outcomes. The IMF included the RMB into the SDR basket hoping a more diversified basket would serve the global economy.

-x-

Works Cited

"About the IMF Responsibilities." *About the IMF Responsibilities*. INTERNATIONAL MONETARY FUND, n.d. Web. 25 June 2016.

Albert, Eleanor. "The China-North Korea Relationship." *Council on Foreign Relations*. Ed. Beina Xu. Council on Foreign Relations, 8 Feb. 2016. Web. 6 July 2016.

"An Explanation of Moral Theories & Traditions." *Seven Pillars Institute Moral Theories Comments*. Seven Pillars Institute, n.d. Web. 25 June 2016.

"China to Continue Promoting More Flexible Exchange Rate." *China.org.cn*. Xinhua News Agency, 25 June 2016. Web. 26 June 2016.

CHONG, Tai-Leung. "What the World Can Gain from Having Yuan in SDR Basket." *Ejinsight*. Hong Kong Economic Journal Company Limited., 27 Apr. 2015. Web. 26 June 2016.

"FAQ." *Q and A on 2015 SDR Review*. INTERNATIONAL MONETARY FUND, 30 Nov. 2015. Web. 25 June 2016.

Gertz, Bill. "China Doubles Aid to North Korea Under Kim Jong-Un." *Washington Free Beacon*. Washington Free Beacon, 11 Mar. 2015. Web. 25 June 2016.

Hunter, Gregor Stuart. "Everything You Need to Know About China's Stock Markets." *WSJ*. Wall Street Journal, 10 July 2015. Web. 25 June 2016.

IMF Finance and Strategy, Policy, and Review Departments. "Criteria for Broadening the SDR Currency Basket." *INTERNATIONAL MONETARY FUND* (2011): n. pag. Web.

"The Indispensable Economy?" *The Economist*. The Economist Newspaper, 30 Oct. 2010. Web. 25 June 2016.

INTERNATIONAL MONETARY FUND. "REVIEW OF THE METHOD OF THE VALUATION OF THE SDR — INITIAL CONSIDERATIO NS." *INTERNATIONAL MONETARY FUND* (2015): n. pag. 3 Aug. 2015. Web.

Jacob, Jijo. "China to Replace US as World's Biggest Economy in Eight Years." *International Business Times RSS*. IBTimes Co., Ltd., 21 Nov. 2013. Web. 25 June 2016.

Kollewe, Julia. "UK and EU Urged to Act on Chinese Steel Dumping after US Raises Duty on Imports." *The Guardian*. Guardian News and Media, 18 May 2016. Web. 25 June 2016.

Li, Jennifer. "Chinese Banks Are Set to Take on More Bad Loans as the Economy Slows." *South China Morning Post*. South China Morning Post Publishers Ltd., 5 Apr. 2016. Web. 25 June 2016.

Olingo, Allan. "Africa to Benefit from China's Push for Yuan as Global Reserve." *Africa Review*. Africa Review, 12 July 2015. Web. 26 June 2016.

"Public Information Notice: IMF Executive Board Completes the 2010 Review of SDR Valuation." *Public Information Notice: IMF Executive Board Completes the 2010 Review of SDR Valuation*. IMF EXTERNAL RELATIONS DEPARTMENT, 17 Nov. 2010. Web. 25 June 2016.

Qi, Liyan. "China Premier Urges Banks to Boost Lending." *WSJ*. Wall Street Journal, 17 Apr. 2015. Web. 25 June 2016.

R., S. "China Knocks on the Reserve-currency Door." *The Economist*. The Economist Newspaper Limited, 5 Aug. 2015. Web. 25 June 2016.

"Special Drawing Right (SDR) Allocations: Questions and Answers." *Special Drawing Right (SDR) Allocations: Questions and Answers*. INTERNATIONAL MONETARY FUND, 5 Aug. 2013. Web. 25 June 2016.

Wildau, Gabriel. "IMF Indicates Shortcomings on Renminbi as Reserve Currency." *Financial Times*. Financial Times, 5 Aug. 2015. Web. 25 June 2016.

Xie, Ye, Lee Spears, and Huang Zhe. "China Limits Stock Market Short Selling to Curb Volatility." *Bloomberg.com*. Bloomberg, 4 Aug. 2015. Web. 25 June 2016.

Zhang, Liqing, and Kunyu Tao. "The Benefits and Costs of Renminbi Internationalization." *SSRN Electronic Journal SSRN Journal* (n.d.): n. pag. Web. 25 June 2016.