

The SDR as a Payment Means: Based on the Background of RMB into the SDR Basket

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Abstract: With RMB climbing to the international stage gradually, China had been taking a series of policies in the process of promoting RMB inclusion into the SDR basket, which could devote to RMB Internationalization. On November 30th, 2015, IMF Board proclaimed to add RMB into SDR basket formally from October 1st, 2016, being the fifth currency except bound, Euro, yen and dollar, as the first emerging-market currency into SDR. This matter arouse many controversies and discussions about the influence and prospect of RMB inclusion in the SDR basket in academia. It is not only inevitable that the inclusion of RMB owed to the blossom of emerging market economics, but in line with the interest of International Monetary System Reform. This paper analyzes and collates some literature and views about the introduction of SDR, the development and reform of International Monetary System, prospect of RMB included into the SDR basket, our countermeasures and conclusion.

Keywords: RMB Internationalization, SDR, Reform of International Monetary System

1. Introduction

After World War Two, Bretton Woods System taking place of the Gold Standard in 1944, set the dollar value and from then on dollar was pegged to gold while other international currency value was pegged to dollar. Under such framework, only gold and dollar could be regarded as reserve assets. However, hence the stability of gold supply, the United States had to bear continuous international payment deficit to enlarge dollar supplement. [1] As American payment deficit mounted and the balance of payments adjustment mechanism didn't play its position, Bretton Woods System was soon on the verge of collapse. In order to maintain the normal operation of the system, IMF set about creating a new reserve asset as an extra supplement to gold. In 1969, IMF officially initiate SDR: the free capital usage right allocated to member states, with which they could exchange for foreign currency from others to pay the international payment deficit or debt, when the international payment deficit occurred. On January 1st, 1970, IMF firstly released 3 billion SDR. And more SDR were released in 1971 and 1972, 3 billion per year. After three years allocations, SDR reached 9.5% in the world

reserve asset that are not gold.

The SDR is originally created to solve the problem "Triffin dilemma" which existed at the later stage of the Bretton Woods System--a system regarding a country's or a few countries' currency as a main composition of international currency reserves, and using them to ensure the operation of the international monetary system, this system is not sound and fragile. [2] The system was first established in 1960 by Triffin (a professor of Yale University). In the 1960s, with the intensity of the international financial market volatility and the continuous outbreaks of dollar crisis, people lost confidence on the stability of the dollar, and highlight the problem that money market is not stable and asymmetry. However, SDR, as reserve asset apart from dollar, arising at the historic moment, became the most urgent task for fund.

In November, 2005, the Board of IMF proposed that the currency in the SDR basket must meet two conditions: one is that it must come from the IMF involvement in the issue of currency or monetary union, namely the economic entity of currencies in the SDR basket is one of the four largest exporters of good and services trade in the world for five years before the effective date in the study period; the other is the currency of SDR must be "free used money". It is just

because of the second condition can't be satisfied, IMF refused the demand which China proposed for the first time to apply for RMB joining the SDR basket. [3]

In 2010, the IMF assessed that the RMB was not yet “free used currency”. After several years of financial market reform, the perfect of central parity of RMB exchange rate formation mechanism, the realization of the marketization of interest rate, the degree of the internationalization of RMB had been rouse. The index of the internationalization of RMB, which is produced by the international monetary institute of Renmin University of China, showed that the index was only 0.02% in early 2010, reaching 2.35% by the end of 2014. The index released by the Bank of China in the first quarter of

2015 even showed that the index is as high as 1.27%, hit a record high level of using the RMB in international financial market. November 30, 2015, the IMF formally announced that the RMB is included in the SDR basket. [4] The RMB holding the proportion of 10.92%, and the dollar(47,14%),the euro(30,93%),the yen(8,33%) and the sterling(8.09%) put together into the SDR basket. The currency weights in SDR are decided per 5 years, but in the reality, it can make adjustment according to exchange rate trend. For example, due to Currency exchange rate fluctuations, the actual weight is apart from the initial ones, which USD, JPY and RMB are over their initial weight. [5]

Table 1. The initial weight and actual weight of SDR (2016.8.8).

| Currency | Initial Weight | Quantity | Exchange Rate | US Equivalent | Actual Weight |
|----------|----------------|----------|---------------|---------------|---------------|
| USD | 41.74% | 0.5840 | 1 | 0.584 | 41.92% |
| EUR | 30.93% | 0.3873 | 1.1086 | 0.42936 | 30.82% |
| JPY | 8.33% | 12.3130 | 102.1100 | 0.1206 | 8.66% |
| GBP | 8.09% | 0.0817 | 1.3082 | 0.1069 | 7.67% |
| CNY | 10.92% | 1.0125 | 6.6530 | 0.1522 | 10.93% |
| SDR | | | | 1.39306 | 100.0% |

Resource: IMF

Notice: The currency exchange rates are all based on USD, where the exchange rates of EUR and GBP use direct quotation, and the one of JPY uses indirect quotation.

2. Development and Reform of IMS

2.1. Three Major Stages

2.1.1. Gold Standard

It started at 1870s, as a stable monetary system. And it can adjust international balance of payment automatically and offer condition for international trade and investment. But maintenance of Gold Standard needs plentiful gold supply. The gold standard was ruined tremendously by economy crisis bursted in 1929, thus British as well as many other countries abolished the Gold Standard in response to the mess chaos in global financial order.

2.1.2. Bretton Woods System

After World War Two, the United States became the largest economy, and it tried establishing a dollar-centered currency system, while England attempted to keep the status of bound. In the Bretton Woods Conference, countries agreed the Agreement of the International Monetary Fund and Agreement of International Bank for Reconstruction and Development, thus the dollar-center international currency system--the Bretton Woods System had been founded formally.

2.1.3. Jamaica System

After the Bretton Woods System disintegrated, the international monetary system stepped into Jamaica System and international finance entered no system period in 1976. As the most important international reserve asset around the world, the value of dollar didn't link up with any heavy metal (gold). And countries widely used dollars due to the

confidence in its stability as credit reserve asset. [6] However it is confirmed that the international monetary system only regarding dollars as single reserve asset, along with the dollar crisis frequently broke down and serious international payment deficit. [7]

Y.L.Chen referred to, dollars still provide global liquidity supply by trade deficit, only causing the flood of liquidity in the America, dollar asset bubble, and subprime crisis expending to the global crisis; while the economic amount and physical volume of foreign in emerging market countries rapidly roes, these countries faced serious currency mismatched problem. [8] The international monetary system is in urged need of reform to cope with “dollar trap”. Claudio Borio once showed “dollar-denominated international currency and financial system can't avoid the risk of financial imbalances, even it would magnify all countries defects”, he thought IMF should build the anchor of more effective policy, since dollars would intensity the instability of global financial system and America can't adjust home financial fluctuation timely. Now different views about the currency system are supported. C.W.Zhang considered the current international monetary system substantially is dollar standard system, and dollars take the international monetary function as credit money released by the Federal Reserve. [9] “Triffin Dilemma” can't solve, and the sufficient supply of dollars and the stability of value can't realize simultaneously, as long as dollars still occupied the main status in the reserve currency and still take as the domestic currency and international currency.

2.2. Reform Process

What the basic flaw of the current International Monetary

System is over-dependence on dollars and lack of inflexible restraint on the printing press. [10] Considering the current pattern of global economic development, it is unreasonable to replace dollars with new sovereign currency, and it is unattainable to build global single monetary system. Because any currency will face the challenge of “Triffin Dilemma” (the power nation must exist overseas market demand, then must generate deficit, and deficit will weaken stronger currency). [11] So, there are two mainstream views about the International Monetary System reform: one is building the diversified dominant international monetary system, the other is super-sovereign international reserve currency and SDR.

2.2.1. Multiple Currency System

This monetary system will contribute to form the competitive regional currency and avoid the state of over dependence on certain sovereign currency. In the antecedent currency system, the low yield of dollar national bounds affected its international status as reserve currency. [12]

Diane B. Kunz once forecast that the whole world will segment three parts: America led by US, Europe led by Germany and Asia led by Japan, establishing the architecture with three pillars of America, Europe and Asia, and it indicated the international financial power is transforming to “equipollence” structure form “supremacy”. [13] Dailami and Masson advocated to build a diversified international monetary system, with US, EU and BRICs as its pillar. After RMB inclusion in the SDR basket, Li Junjiu deemed the impact of promoting international system more diversified is not immediate, and it is more possible to form a situation: “one superpower (dollar)”, “two major powers (Euro, RMB)”, two weak powers (bound, yen)”, rather than three pillars of “dollar, Euro and RMB”. [14]

Although the diversified dominant international monetary system avoided the exchange rate risk of sovereign credit currencies acting as reserve currencies, “Triffin Dilemma” still exists radically taking sovereign currency as reserve currency. At the same time the exchange rate between major sovereign currencies is unstable, and the exchange rate fluctuation will cause additional amplification. In conclusion, the diversified dominant international monetary system cannot provide a truly stable currency system.

2.2.2. Super-sovereign International Reserve Currency

The super-sovereign international reserve currency refers to a kind of currency released by a currency management mechanism surpassed sovereignty, as unite of account, medium of exchange and means of hoard. Especially since China’s central-bank governor, X.C. Zhou, proposed the creation of “a super sovereign reserve currency” to avoid “Triffin Dilemma” in March, 2009, endorsed by Russia Brazil and other emerging market countries, super-sovereign international reserve currency became a hot topic. Williamson thought, in the current international monetary system, once the excessive debt continued to rage and the confidence of American market collapsed, it will severely affect the stability in the American financial market, even

expanding to the whole world, so he supported that strengthening the function of SDR could ease the economic crisis by dollar fluctuating.

3. Prospect

The inclusion to the SDR is equivalent to the endorsed letter of credit, IMF made clearly RMB as international monetary, which clarifies the equal position of RMB comparing with dollar, yen, Euro and bound. [15] Christine Lagarde, the IMF president, claimed, “The decision of the Board, putting RMB into the SDR basket, is an important milestone meaning accelerating Chinese economic integration into the global financial system. This decision is also the recognition about Chinese government’s reform achievement on currency and financial system in the few years. The continuation and deepening will bring more dynamic international currency and financial system, in reverse the latter will support Chinese and global economic growth and stability.” [16]

According to the IMF data, in the past five years of one cycle, dollars and yen account for well under the average. [17] Since sub-loan crisis of the United States in 2008, America always implemented quantitative easing monetary policies to step off the period of economy depression, but the dollar continued slide against other currencies which put pressure to the countries holding American bounds. Meanwhile due to the Eurozone debt crisis and yen suffering economic depression and Abenomics, even the voices of bound exiting Eurozone, all these matters increased the uncertain factor on currency fluctuation. RMB inclusion to SDR basket means that RMB becomes the first sovereign currency in the emerging market, which can relieve the dollar, bound devaluation pressure (David Marsh, 2015b). At the same time, Ben Shenglin mentioned RMB joined called “elite club” as developing-country currency, contributed to promoting the power of the emerging-country and driving SDR to play a more important role.

3.1. Functions of Exchange Rate

The expectation of inclusion in the SDR basket can analysis mainly from two points: The influence of national market and international market. While it can help promote RMB internationalization, we need to realize that it is uncontrolled to regulate exchange rate and interest rate fluctuation in the home market, just as dollars cannot stabilize the American market as the first currency in circulation. China should avoid new financial crisis taking dollars as a lesson.

Inclusion into SDR inevitably causes the whole financial market’s reform, triggering new round tide of global central bank and sovereign wealth fund absorbing RMB assets. The reform and development of Chinese financial cannot be apart from three aspects: Market-Oriented reform of RMB interest rate, the management of international capital flow and the openness of domestic bond market. The RMB exchange rate

floating bands maybe remains widening, according to the form process. The floating range in 1994 is 0.3%, expanding to 0.5% in 2007, and expanding to 1% in 2002, even the range from 1% to 2% in 17th, March, 2014. So, in the long term, with the advance of RMB internationalization, the central bank will gradually reduce the exchange rate intervention. It is anticipated that the rate range may be 3%, even wider, and it is also common to reduce reserves against deposit significantly for increasing monetary multiplier. The improvement of RMB status will urge more and more countries or districts to reinforce the cooperation with relative Chinese institutions. At present, People's Bank of China had signed bilateral currency swap agreement with 34 countries and districts, a total of 3.2535 trillion RMB. [18]

3.2. Internationalization

With RMB being into the SDR baskets and the integration of Chinese financial system into global system, it's helpful to solve the Gini coefficient unbalance. Creating a new regulating mechanism by cash flow and liberalization of capital account, helps establish the market-oriented financial system in home, which means RMB interest rate is decided by capital flow direction. It not only promotes the economic inner balance, but allows Chinese consumers to turn into primary urge of economic gain in the future. R.R. Zhao proceeded empirical analysis on the economic function of SDR as foreign exchange reserve property using Monte Carlo Simulation, manifesting that joining the SDR basket offers an opportunity for risk reduction and offers a better investment tool for foreign exchange assets management. [19] Since 2012, Chinese economy is always in sluggish market, so this inclusion can reduce capital flow regulation, "and help Chinese company expansion into overseas market, lower the borrowing cost, promote enterprise investment abroad. With the financial services globalization, a wider variety of enterprises will go abroad." [20]

Inclusion to SDR expedited the process of Chinese financial market openness, and formed forced power to complete foreign exchange market mechanism and liberalization of capital account. Some scholars supported that it need analysis whether joining SDR basket is favorable news or not for Chinese financial market from the long term and short term. But from short term, the strike to Chinese economy is more due to mental factors rather than substantial factors. [21] L.S. Xiao proposed the SDR's role played in the international monetary system is limited, so it can't material alteration in a middle or short term. Although in the short term, the scale of RMB as reserve currency is limited, joining SDR basket remains a limited access to realize internationalization and provides a new mechanism for our international monetary system.

3.3. Enterprise

RMB internationalization started from trade settlement, expanding to the direct investment and financial field will become new power for our trade development, especially

with the extension of trade financing and field. Trade is engine of economic growth, financial is booster of trade. In the foreign trade growth, financial plays an important role, expect catching globalization historical opportunity, implementation of export promotion policy and development of labor-intensive industry. [22] After RMB joined SDR, the global bulk commodity market was not only pegged on US dollars, more focused on RMB trend. Commodity price used RMB could avoid risk and reduce the enterprise operation cost. Company or individual can use RMB for settlement, reducing the exchange rate risk and being more convenient in foreign trade.

As for the influence on enterprise, the approval degree and popularity of RMB will improve greatly in board, so there are more discourse power on currency sort in the foreign trade and daily items. Compared the before situation, foreign companies could receive extraneous earnings on monetary exchange rate, tax calculation and so on, which can enhance daily operating cash, improve capital turnover rate and enlarge management scale. In the meanwhile, inclusion into SDR basket is helpful to improve our companies' existent environment. [23] Nowadays, the home economy is on slump period, connected to RMB devaluation to some extent. After this matter, country may promulgate some policies to promote RMB appreciation and improve RMB flow.

While, some challenge had taken place for the enterprise. What the biggest challenge is from exchange rate change. The huge exchange rate fluctuation impacts the companies' financial situation. Learning from history, what formation mechanism of parity rate adjusted in August, 2015, caused RMB exchange rate depreciation as cliff type.

3.4. Challenge

In addition, RMB joining the SDR basket also brought certain risk and challenging. The interest rate and exchange rate floating faced more "marketization responsibility", posing challenging to our economic competition. Meanwhile the macroeconomic regulatory more difficult, part of the domestic economic lopsidedness will be amplified by the change of international economic financial environment. [24]

4. Countermeasures

After the RMB has been put into the SDR basket, though the IMF guaranteed the RMB as endorsement, the central banks of other countries and international currency investors won't hold the RMB on the basis of its weight in the SDR basket. Even the key lies in the future trend, growth of Chinese economy and the process of Chinese financial reform. On the whole, the join of the RMB into the SDR basket is a two-edged weapon, and the government should make much more preparations. This join is not only the approval of Chinese economic strength, but also brings a lot challenges. K. Song considered that there were challenges in three aspects faced with when the RMB joined the SDR basket: the openness of the capital account, the lack of time

and buffer on forcing the domestic reforms in short term, the high political costs and economic risk caused by excessive political interference (IMI.). However, the SDR is still a kind of reserve assets at present and as product of political compromise, not playing the function of international currency. The participation in the SDR means that the ratio of emerging market countries in the IMF has been increased, and it accords with the developing distribution of various countries at this stage.

As for the join to the SDR, there may be more symbolic meanings in a short time, but it must influence the economic reform deeply in the long term. China should pay more attention to the opportunities and challenges after this matter, relying to the dilemma actively. L.S.Xiao indicated that China should regard the inclusion as a chance, which accelerated the process of RMB internationalization and participated in the international currency affairs positively. We ought to take measures to establish SDR liquid market, or issue SDR-denominated bonds, enhancing the SDR's status in reserve currency. Furthermore, to solve negative effects of the swing currency market and interest rate market, generated by joining the SDR, the government must strengthen the dynamic monitor to cross-border funding flows and guard against financial risks.

S.B.Chen put forward that there were three aspects of financial reforms carried out by our country now: interest rate liberalization, exchange rate formation mechanism and Capital Account Convertibility of RMB. Market-based reform of interest rates needs to restart wholesale deposits as an opportunity, perfect the framework of interest rate regulation and benchmark rate, improve the pricing ability of financial institutions, abandon the domestic deposit rate in good time, and drive interest rate liberalization. As for exchange rate formation mechanism, we are supposed to escalate the flexibility and amplitude of exchange rate and gradually complete RMB rate bilateral floating mechanism on the condition of keeping exchange rate basically stable on a reasonable and balanced level, enlarging the impact of market in exchange rate formation mechanism. Another, it need promote qualified overseas investment pilot projects for domestic individual investors and form organizations and individuals cross-border mutual investment, by capital account convertibility, mechanism of cross-border RMB investment, and the channels for personal cross-border investment. In regard to the openness of domestic bond markets, on the one hand, we can take relaxing the threshold of foreign investors' entrance to Chinese inter-bank especially bond market into consideration, on the other hand, we may cancel the examination and approval of foreign debt scale, with the view of the Federal Reserve's expectation to interest raising and currency appreciation, a rational enterprise won't urge to exchange its debt into foreign currency, therefore it is good time to reform the examination and approval system of foreign debt scale.

Y. Y. Wang used to put forward RMB qualified for the SDR basket would make Chinese enterprises have more independent pricing power, which could control the exchange

rate risk of using USD or a third party currency effectively as well as facilitate trade enterprises development. [25] However, the marketization of RMB exchange rate could be unstable which should not be neglected. Si-bo Chen (2016) also considered Chinese corporations, especially foreign trade type, should set up a correct exchange rate risk awareness to deal with exchange rate's fluctuation positively, to stick to the principle that says "The purpose is to hedge the value and to lock risk, based on the basic business.", to eliminate their own exchange rate risk and expanding overseas step by step3.s.", to eliminate their own exchange rate risk and expanding overseas step by step3.

We can observe that adding RMB to the SDR would drive the yuan internationalization and force domestic financial reform, while at the same time, we are required to focus on its potential risks. Dong Hongxia has proposed that joining the SDR would not only raise the fluctuations of domestic market finance, but also shock the RMB pricing power in the territory. According to the central bank data, in 2014, offshore trading volumes on RMB had exceeded onshore ones, moreover, offshore market ran to be fully marketable. With adding RMB to the SDR basket, investment channel of offshore market had been broaden and product categories of RMB have been increased, thus RMB pricing power in onshore market has been shocked. [26] In consequence, the mechanism of RMB pricing power in onshore market should be marketable as soon as possible and the coordinated reform on the real economy have to keep pace with financial reform, including SOE reform and the service industries marketization, except for existing market-oriented reforms on exchange rate and interest rate.

5. Conclusion

We are all agreed that a clearing arrangement of some sort that links official and private SDRs is essential to the further development of the SDR. And then with the inclusion of Renminbi in the SDR basket, we should face the new challenge and opportunity.

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