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EXECUTIVE SUMMARY

The International Monetary Fund (IMF) recently concluded its quinquennial review of the composition of the Special Drawing Right (SDR), accepting the Chinese currency into the SDR basket alongside four major international currencies — the US dollar, the euro, the British pound and the Japanese yen. The Chinese government has spent a great deal of energy and political capital to achieve this outcome. This policy paper explains China's interest in this seemingly exotic and technical pursuit, identifying the political and economic motivations underlying this initiative. It discusses the controversial reactions to China's bid for the SDR basket from the international community and from various groups within China. It also explores some plausible and implausible consequences of the renminbi's (RMB's) inclusion in the SDR basket. It argues that the inclusion of the Chinese currency in the SDR basket may well play a facilitating role in China's financial liberalization, but it does not in itself transform the RMB into a global reserve currency. The latter will involve a more protracted process, requiring serious institutional reforms in China.

INTRODUCTION

In the 1960s, the Bretton Woods system created after World War II came under increasing stress. The world economy had grown much faster than the supply of gold. Meanwhile, with the United States running ever-larger budget and balance of payments deficits, countries holding the US dollar in their reserves (linked to gold) had growing concerns over the sustainability of the dollar-gold link. In 1969, the IMF created the SDR to complement gold and the US dollar in providing international liquidity under the fixed exchange rate regime. As a kind of "paper gold," the SDR could be used to settle international claims among governments.

In the early days of the SDR, its value was equivalent to the gold content of one US dollar. After the par value system collapsed in 1973, the value of the SDR became determined by a basket of currencies. At first, there were 16 currencies in the basket, representing the largest trading powers in the world. In the early 1980s, there were five currencies in the basket, also based on their importance in international trade. When the euro was launched in 1999, the composition shifted to the current four currencies — the US dollar, the euro, the British pound and the Japanese yen (Obsfeld 2011; Wilkie 2012). The SDR is not a real currency used or traded in the private market. Instead, as a composite reserve currency, it is an accounting unit and a potential claim on various national currencies held by other IMF members.

Since its inception, the SDR has been seen as an arcane concept familiar only to a small number of international monetary specialists. Moreover, the SDR has only played a minor role in the international monetary system. Until 2009, the IMF had only allocated 21.4 billion SDR, which made up less than one percent of the non-gold reserves (Helleiner 2014). Two new allocations in 2009 raised SDR to 204 billion, but that is a very small portion of over US$11 trillion of global reserves today.

The SDR has recently garnered increasing public attention, appearing in news headlines and making up the talking points of politicians and pundits alike. The unlikely new spotlight on the SDR has largely resulted from China's drive to have its own currency — the RMB — included in the SDR basket. The IMF reviews the composition of the basket every five years. As the latest round of review picked up pace in early 2015, the Chinese government explicitly put this request to the IMF (Xinhua 2015a).[1] Throughout the year, Chinese officials have put a great deal of energy and political capital into this pursuit. At the end of a lengthy and controversial review process, on November 30, the IMF's executive board approved the inclusion of the RMB in the SDR basket.

China's eagerness to join the SDR basket has been puzzling for many observers. Some have dismissed it as largely symbolic, devoid of any real effect. This policy paper discusses three questions: Why has China been so interested in the SDR, and particularly in having its currency included in the SDR basket? How has China's request been received internationally and at home? What consequences might ensue now that the RMB has joined the SDR basket?

EXPLAINING CHINA'S FOCUS ON THE SDR

China's active pursuit of the RMB's inclusion in the SDR basket should be understood against the larger context of its sustained effort to internationalize the Chinese currency, create a more diversified international currency system and accelerate financial reform in China. Different groups in China prioritize these goals differently, but they have all seen the SDR initiative as instrumental for their causes.

RMB Internationalization

A widely shared view among Chinese policy makers and analysts is that the inclusion of the RMB in the SDR basket is desirable because it is the next step in internationalizing the Chinese currency. The Chinese government has actively pushed for the international use of the RMB since

1 In 2010, China showed an interest in joining the SDR basket. Chinese officials later called for SDR reform. Most notably, at the Group of 20 (G20) summit in St. Petersburg in 2013, China's President Xi Jinping called on the IMF to reform the SDR basket. But those efforts were not nearly as consistent or intense as the recent push of RMB into the SDR basket.

late 2008. For the first couple of years, this involved the use of RMB in bilateral trade settlement. Later, the Chinese government allowed RMB-denominated foreign indirect investment in and out of China and fostered an offshore RMB-denominated bond market. In addition, China has signed a growing number of currency swap agreements, providing foreign central banks with RMB, and permitted the trading of RMB directly with other currencies without going through the US dollar (Eichengreen and Kawai 2014).

The progress in the international use of the RMB has been remarkably fast, but the internationalization of the Chinese currency is far from complete. As Benjamin Jerry Cohen (1971) first conceptualized it over four decades ago, the roles of an international currency can be classified as three functions at two levels of analysis. At the private level, an international currency can serve as a medium of exchange (as in foreign exchange trading and trade settlement), as a unit of account (as in trade invoicing) and as a store of value (as in financial markets). An international currency can serve the same three functions at the official level. As a medium of exchange, it can be used to intervene in the foreign exchange market. As a unit of account, it can be an exchange rate anchor. As a store of value, it can be held as a reserve currency. Table 1 summarizes these functions of an international currency.

Table 1: Functions of an International Currency

Function	Medium of Exchange	Unit of Account	Store of Value
Private level	Forex trading, trade settlement	Trade invoicing	Investment
Official level	Intervention currency	Exchange rate anchor	Reserve currency

Source: Based on Cohen (1971).

The international use of the RMB has made impressive inroads in the private sphere. According to data provided by the Society for Worldwide Interbank Financial Telecommunication, as of mid-2015, the RMB ranked second in international trade settlement, fourth in global payment and sixth in foreign exchange turnover (Song 2015; Li 2015b). However, these rankings may be overstating the role of the RMB. In international trade settlement, the RMB accounts for 9.1 percent of the total issuance of letters of credit, a long way behind the 80.1 percent for the US dollar (Li 2015b). In global payments, the RMB only makes up 2.79 percent of the total, similar to the yen (2.76 percent), and well behind the sterling (8.45 percent), the euro (27.20 percent) and the US dollar (44.82 percent) (Wildau 2015a). In foreign exchange trading, the RMB accounts for 2.8 percent (IMF 2015b). The international use of the RMB at the official level has been more limited. According to the IMF's latest report, in the first quarter of 2015, the US dollar and the euro account for 64 and 21 percent, respectively, of global official reserves, followed by the yen and the sterling at about four percent each, and then the Canadian dollar and the Australian dollar at about two percent each. The RMB, held by nearly 40 countries in their official reserves, accounts for about one percent of the global total (ibid.).

The Chinese government sees it as highly desirable to expand the official use of the RMB, especially to promote the RMB as an international reserve currency. The hope is that once the RMB achieves the status of a reserve currency, China will not have to hold massive foreign reserves in the form of dollar-denominated assets, which scholars have shown to have been very costly to China financially (Brown and Wang 2015; Jin, Lombardi and Hu 2015).[2] China will also be able to lower the cost of borrowing, and to reduce the transaction costs of trade and investment, as well as the exchange rate risks. In addition, there are political and geopolitical benefits of being the issuer of an international reserve currency. Many in China believe — rightly or wrongly — that entering the SDR basket will transform the RMB into an international reserve currency.

While there is widespread support in China for further internationalizing the RMB, and for the RMB's inclusion in the SDR to accelerate this process, a closer examination of the Chinese discourse shows that proponents of these moves have different priorities. Some of them see the RMB's entry into the SDR basket and further RMB internationalization as steps in reforming the international monetary system, in particular in diminishing the role of the US dollar. Others are more interested in the SDR initiative and RMB internationalization as mechanisms to accelerate China's own financial liberalization, in particular the liberation of the exchange rate regime and the capital markets. These goals are not mutually exclusive, but it is important to distinguish them.

Reforming the International Monetary System

Chinese policy makers have long been dissatisfied with the dominant role of the US dollar in the international monetary system. Since the global financial crisis of 2007-2008, their criticism has become more vocal than ever before. High on their reform agenda has been the diversification away from the dollar as the main reserve currency. In spring 2009, Zhou Xiaochuan, the governor of the People's Bank of China (PBoC), made a widely publicized statement that was critical of the role of the US dollar in the international monetary system and placed hope on the SDR, stating, "it serves as the light in the tunnel for the reform of the international monetary system" (Zhou 2009).

2 It is important to recognize, however, that China's massive holding of dollar-denominated assets has resulted from its export-led growth strategy. While the holding of low-yielding US government securities has been costly to China financially, the overall strategy has served China well.

China was not alone in proposing the wider use of the SDR as a step to reform the international monetary system. Following the global financial crisis, the G20 and the BRICS (Brazil, Russia, India, China and South Africa) developed proposals to expand the role of the SDR. French President Nicolas Sarkozy was particularly enthusiastic in pushing for new thinking along these lines. At an unofficial level, similar views were expressed by pundits and experts, such as the Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System (Helleiner 2014).

For a little while, there seemed to be consensus among many governments and analysts that a national currency was simply too tied to the self-interest and economic policy of the issuing country to serve as the reserve currency for the rest of the world. As the epicentre of the financial earthquake, and with serious fiscal and regulatory problems, the United States seemed to be losing its ability to continue to be the main provider of international liquidity. These calls for reform echoed the voices in the late 1960s and early 1970s, when US fiscal and foreign policy overstretch generated a crisis of confidence in the dollar. This was, in fact, the driving force behind the creation of SDR (Wilkie 2012).

The statement of Governor Zhou in 2009 may have been the first time the world noticed China's position on the SDR and its role in reforming the international monetary system, but the idea expressed in that statement had been developing among China's policy circles for quite a while. For example, in an article published in 2000, China's current executive director at the IMF (then a researcher at the PBoC) laid out the main arguments in Zhou's statement, including the prospect of the SDR replacing the dollar as the main international reserve currency, and called for China's currency to become a major component of the SDR (Jin 2000). In other words, a Chinese vision of reforming the international monetary system featuring a greater role of the SDR has formed gradually over at least the last 15 years.

Ironically, in the early days following the global financial crisis, the promotion of the SDR and RMB internationalization seemed to be two different strategies to diminish the role of the dollar. Scholars pointed out that while both would serve to diversify the international currency system, it was not clear if China was more interested in the multilateral strategy of SDR expansion or in the bilateral strategy of RMB internationalization (Chin and Wang 2010). China's recent effort to have the RMB included in the SDR basket seems to be bridging the two strategies.

Reforming China's Financial System

Alongside the agenda for international monetary reform, another goal for some supporters of RMB internationalization, including its entry into the SDR basket, is to promote financial liberalization in China. For them this is an even more important task. Financial repression has been a serious obstacle for economic restructuring, innovation and equitable development. As China exhausts its old model of extensive economic growth, the imperative for change is more urgent than ever before.

While Chinese leaders have long recognized the need for financial reform, the various interest groups have not formed a consensus on how far and how fast to move in that direction. On the one hand, reformers — many of whom are in the PBoC — would like to see greater financial liberalization in a timely fashion, including freer flow of capital and less government control of the interest rates and exchange rates. These measures, they believe, are necessary for developing a healthy and sustainable financial system and, in particular, for making effective monetary policies. On the other hand, opponents — including economic planners, state-owned enterprises and the exporters of tradable goods — have sought to slow down the pace of financial liberalization because it threatens their bureaucratic and economic interests (Wang 2014; Steinberg 2015). In this context of political gridlock, the internationalization of the RMB, especially the bid to join the SDR basket, has emerged as a useful instrument for the reformers to strengthen their position.

According to the IMF, currencies must meet two criteria in order to become part of the SDR basket — they must be "widely used," i.e., they must be currencies issued by the world's largest exporters of goods and services, and "freely usable," i.e., these currencies are widely used to make payments for international transactions, and widely traded in the principal exchange markets. These criteria ensure that the currencies in the SDR basket play a central role in international trade and financial transactions.[3] China, as the world's number one trading country in goods and the number two country in goods and services combined, no doubt meets the first criterion. To what extent China meets the second criterion has been more controversial. Despite gradual expansion of channels of capital flow in and out of China, the capital market of the country still remains under the tight control of the government, which

3 The second criterion came into effect as a result of an update of the IMF policy in 2000. As noted earlier, previously the SDR basket consisted of currencies widely used in international trade.

has hindered the wide use of the RMB in international financial transactions.[4]

Advocates of financial liberalization in China have seized the second SDR entry criterion for their cause. For instance, when Premier Li Keqiang met with IMF Managing Director Christine Lagarde in March 2015, his request for the RMB to enter the SDR basket was accompanied by strong statements about financial reform in China: "China will speed up the basic convertibility of yuan on the capital account and provide more facility for domestic individual cross-border investment and foreign institutional investment in China's capital market" (Xinhua 2015a). In the months leading up to the IMF's decision, PBoC officials often linked capital market opening and greater RMB convertibility on capital account with China's preparation for the RMB's entry into the SDR basket (You 2015). In his statement at the IMF in April 2015, the PBoC's Governor Zhou (2015) clearly said that "we look forward to the upcoming quinquennial SDR review, given its pivotal role in strengthening the SDR's representation of the multilateral global economy, and in contributing to the reform of not only the international monetary system but also the individual member's financial system." Indeed, explaining the IMF's recent decision to accept the RMB into the SDR basket, Lagarde stated that it is "a recognition of the progress that the Chinese authorities have made in the past years in reforming China's monetary and financial systems" (IMF 2015d).

CONTROVERSIES OVER CHINA'S SDR INITIATIVE

The push by the Chinese government to have the RMB included in the SDR basket has met with mixed reactions both internationally and at home. For some commentators, the RMB's entry into the SDR basket is of little significance, except perhaps as a symbolic marker of China's status in the world. But others take it more seriously, whether they support or oppose it.

International Response

As the issuer of the SDR, the IMF has been at the centre of evaluating whether the RMB should be allowed to join the other major international currencies in the SDR basket. Since early 2015, officials at the IMF have sent out encouraging signals. In March 2015, discussing China's request for the IMF to accept the RMB into the SDR basket, Lagarde stated that it was not a matter of whether but when. In the months that followed, the IMF conducted detailed reviews of China's financial and monetary policies. In May, the IMF declared that the Chinese currency was no longer "undervalued" (IMF 2015a). In July, the IMF welcomed the PBoC's shift toward more market-based methods to determine the RMB's exchange rate (Mauldin 2015). In August, the IMF announced that the current makeup of the SDR basket would be extended to September of 2016, which would "allow users to adjust to a potential changed basket composition should the Executive Board decide to include the RMB" (IMF 2015c). In November, the IMF's staff determined that the Chinese currency met the criterion of being "freely usable," thus clearing the technical obstacles for the RMB to join the SDR basket. On November 30, the IMF's executive board decided that as of October 1, 2016, the RMB will be included in the SDR basket.

However, the positive outcome of the IMF's decision does not mean the review process was without controversy. For much of the year, the US government was quite cautious in its response to China's quest. US officials repeatedly pointed out that the RMB was far from being fully convertible and "freely usable," and did not yet meet the standard for inclusion in the SDR (Lew 2015). It was only in September when Chinese President Xi Jinping and US President Barak Obama met in Washington that the two sides issued a statement that the United States supports the SDR's inclusion of the RMB "provided the currency meets the IMF's existing criteria in its SDR review," softening the earlier American position (Mayeda 2015). Japan was similarly reserved (Taylor 2015). The lukewarm attitude of the United States and Japan was not surprising given their general unease about China's growing assertiveness in its foreign policy, including its financial statecraft. Just as they have expressed serious concern over the hardline policy of the Chinese government on territorial issues in the East and the South China Sea and reservations about China's launch of the Silk Road programs, including the Asian Infrastructure Investment Bank (AIIB), American and Japanese policy makers were wary of another victory in China's striving for status and influence by entering the SDR basket.[5]

In contrast, European countries were more lenient when judging if the RMB met the "freely usable" criterion. The governments of Germany, France and Britain emphasized

4 Many commentators have taken the "freely usable" criterion to mean that the RMB must be free-floating and fully convertible on capital account. However, according to the IMF, "The concept of a freely usable currency concerns the actual international use and trading of currencies, and it is distinct from whether a currency is either freely floating or fully convertible. In other words, 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 may not be necessarily widely used and widely traded (due to the size and relative importance of that economy in international transactions)" (IMF 2015c). I thank the two anonymous reviewers for emphasizing this point.

5 The Chinese government is well aware of the anxiety. Chinese officials have gone out of their way to stress that their new initiatives are not meant to undermine the existing international financial order. With regard to the SDR, for instance, the chief representative of the PBoC in North America states specifically that "even if the RMB becomes a reserve currency, it will not affect the core status of the US dollar" (Song 2015).

how widely used the RMB has become in international trade and investment and how far China has come in liberalizing its financial system. They expressed their support of the RMB's inclusion in the SDR basket early on, citing the trajectory of China's reform. For example, at a meeting in China earlier this year, a German central bank official stated "the German side supports China's goal to add the RMB to the SDR currency basket based on existing criteria," and "we appreciate China's recent development and progress towards liberalization" (Taylor 2015). Less preoccupied with the global competition imperative of the United States and spared the geographic proximity of Japan to China, European countries have been generally more relaxed in their reaction to China's foreign policy initiatives. Their positive attitude toward China's SDR bid is a continuation of the pragmatism they demonstrated with regard to China's earlier initiative in launching the AIIB.

Last, but not least, many developing countries have been sympathetic toward China's position. Like China, they see the old international monetary system as being dominated by Western powers, in particular the United States. They agree with China that developing countries deserve greater voice and representation in global governance. In fact, China has shown solidarity with other developing countries in this area. In 2011 Deputy PBoC Governor Yi Gang called for the SDR to include the currencies of emerging economies, such as Saudi Arabia and Korea (Reuters 2011). In this context, it is easy to understand that they hope to see China's status and influence grow in the international financial system, including through the restructuring of the SDR basket.

Domestic Debate

Just as the world responded to China's SDR initiative in a mixed fashion, there was not full consensus on the issue within China. Broadly speaking, there were three perspectives as to whether and how fast the RMB should join the SDR basket.

One perspective advocated early entry of the RMB into the SDR basket. Some arrived at this perspective from a desire to increase China's international influence. They equate joining the SDR with the RMB's emergence as an international reserve currency, which they believe will challenge the role of the dollar and undermine the dominance of the United States in international finance. For instance, one influential commentator argued that the slow pace of RMB internationalization cripples China; as long as China uses other people's currency for trade and payment, China will not have its own voice. If China's currency, like its manufacturing, can go out into the world, it will expand China's soft and hard power by more than a third (Gong 2015). Others came to the same perspective from considerations of domestic financial reform. As noted earlier, many officials at the PBoC have been quite enthusiastic toward the RMB's early inclusion in the SDR. They argued that joining the SDR requires a more liberal and sophisticated financial system in China. This is precisely what China needs for its economic restructuring. The sooner China can implement the necessary reforms to meet the standards of SDR inclusion, the better it will be for the country's long-term well-being.

A second perspective was more cautious and urged patience. The rationale behind the caution is that for the RMB to be included in the SDR basket, China would have to accelerate financial liberalization too much and too fast. Proponents of this position believe that suddenly relaxing control of interest rates, exchange rates and financial markets is an irresponsible policy that would undermine the financial stability that has facilitated China's remarkable economic growth in recent decades (in contrast to the disastrous experience of many developing countries in Latin America and other parts of Asia). From this perspective, the cost of the SDR initiative outweighs the benefit (Niu 2015). Yu Yongding, a well-respected and outspoken monetary expert, has often warned against moving too fast in liberalizing China's capital account because of the risks of "hot money" inflow and capital flight, suggesting that it is unwise to do so in order to meet the SDR requirement (Yu 2015).

Finally, some analysts went beyond the timing issue and questioned the conditions under which the RMB should join the SDR basket. They saw the first criterion set by the IMF as reasonable, i.e., a currency should be widely used in international trade in order to be part of the SDR. But they questioned the rationale for the second criterion, i.e., the currency in question has to be widely used in international financial transactions. They argued that for all practical purposes, meeting this criterion would require the RMB to be fully convertible under capital account. In a world where financial transactions are massive, speculative and increasingly detached from the real economy, full convertibility of the Chinese currency poses risks to China's financial stability and undermines its exchange rate policy. Nor is it good for the global economy, which has suffered the disastrous consequences of poorly regulated financial flows. They argued that China should not give in to this condition. Instead, it should demand a change of rules: the IMF should let the RMB join the SDR basket under partial convertibility. This way China can promote its currency safely and help reform the irrational nature of the current international financial system (Zuo 2013).

In the end, it seems that the first perspective had the upper hand and the backing of China's top leaders. As mentioned before, in the months leading up to the IMF's decision, the Chinese government accelerated financial reforms associated with the SDR initiative. This was quite notable in the case of the exchange rate regime. In November 2014, the Chinese central bank said it had "largely" withdrawn from intervention in daily foreign exchange business.

In June 2015, the PBoC stated that it would continue to reform the exchange rate formation mechanism. In August, the PBoC surprised the world by introducing a new and more market-based method for setting the central parity rate as the starting point for daily RMB trading. In the past, China's central bank set the daily central parity rate of exchange in a somewhat arbitrary way. Under the new policy, the PBoC would fix the daily central parity rate based on the previous day's closing rate. Compared with the old method, which involved the PBoC overriding the market, the new method allows for the supply and demand in the marketplace to play a more important role in determining the value of the RMB. The IMF and some informed observers immediately welcomed the change (Mauldin 2015; Lardy 2015).

With regard to capital account liberalization, in March 2015, Governor Zhou called for a "basically open capital account" to be implemented by the end of the year. Chinese officials pledged to ease control on both inflow and outflow of capital, including granting full access for official reserve managers and their agents to the onshore fixed-income and foreign exchange markets, increasing the amount of investment other long-term foreign investors can make in China's financial markets, and loosening restrictions on individual domestic investors going abroad (PBoC 2015). The Chinese government is also planning to launch a connection between the Shenzhen stock market with the Hong Kong stock market, after the Shanghai-Hong Kong Connect model, allowing Hong Kong investors to purchase domestic shares without prior approval.

Despite the slowing down of China's economic growth, the turmoil in the Chinese stock market over the summer and the rapid reduction in China's foreign reserves, the Chinese government pressed on with SDR-related reforms.[6] At the end of August, the State Administration of Foreign Exchange began to publish foreign reserves data for the first time according to the IMF's Reserves Template, as an important step toward joining the SDR basket. In October 2015, China's finance ministry started to issue three-month bills each week, following the example of the currencies in the SDR basket, for which three-month government bond spot rates serve as the reference interest rates. Also in October, the PBoC removed the ceiling of bank deposit interest rates (having removed the ceiling of lending interest rates much earlier). Interestingly, in September, the Chinese Communist Party's Central Committee and the State Council issued a joint document on constructing an open new economic system. Apparently prepared in May 2015, this document calls for deepening financial reforms in China, furthering RMB internationalization, and accelerating capital account liberalization (Xinhua 2015b). The issuance of the document after an eventful summer in the Chinese economy indicated the top leadership's strong determination to carry on financial liberalization against likely rising opposition.

Skeptics contend that the inclusion of the RMB in the SDR basket is purely symbolic and without any real effect. But the intensity of the international and domestic controversies over China's SDR initiative suggests that it is not entirely "much ado about nothing." The next section takes a closer look at what effects may result from the RMB's entry into the SDR basket.

RMB IN THE SDR BASKET: SO WHAT?

Now that we know the RMB will enter the SDR basket next fall, what effect will that have for China? Will it enable the RMB to become an international reserve currency, as the Chinese government desires? If not, will it have other consequences?

Many in China seem to connect the RMB's inclusion in the SDR basket with its status as an international reserve currency. For some there is an assumption that once the IMF accepts the RMB into the SDR basket, it has somehow given approval for the RMB to become an international reserve currency. This connection is highly questionable. The inclusion of the RMB in the SDR basket does not in itself make the Chinese currency an international reserve currency. Whether and how much a currency is held by governments around the world as part of their official reserves depends on a number of factors, including convertibility, credibility and liquidity. The IMF (or any other international organization, for that matter) cannot dictate what currencies countries should hold in their reserves.[7]

In theory, a currency's inclusion in the SDR basket should be a recognition of its status as a reserve currency. In other words, the IMF's acceptance of the RMB into the SDR basket should be a *result* rather than a *cause* of the RMB's internationalization. However, as discussed in the previous section, how internationalized the RMB really is has been a controversial question. There have been

6 China's stock market bubble began to burst in June. In a month, the A-shares on the Shanghai Stock Exchange lost 30 percent of their value. In August, the index fell further, down by 60 percent since June. The Chinese stock market collapse pulled down other stock markets to various degrees. Meanwhile, China's foreign reserves fell by nearly US$94 billion in August as the Chinese government tried to stabilize the RMB and the financial market.

7 Some market analysts believe that big moves will result from the RMB's inclusion in the SDR. A report by Standard Chartered predicts that the RMB's SDR status will lead to US$1 trillion in net purchases of Chinese onshore bonds by 2020 and AXA Investment Managers predict that if the RMB joins the SDR basket, 10 percent of the global reserves will shift to the RMB (Li 2015a). A recent Chinese study estimates that if the weight of the RMB in the SDR basket is 10 percent (very close to the IMF's actual allocation of 10.92 percent to the RMB), the demand for RMB-denominated assets will amount to US$1.9 trillion, which is about 19 times more than the current supply (He and Zhu 2015). Such estimates may be exaggerating the effect of the IMF's seal of approval, at least in the short run.

different opinions, especially with regard to how freely usable it is. Although the IMF has recently determined that the RMB meets the criteria of inclusion in the SDR basket, it is unclear whether this stamp of approval will lead many countries to dramatically increase their holding of RMB in their official reserves.[8]

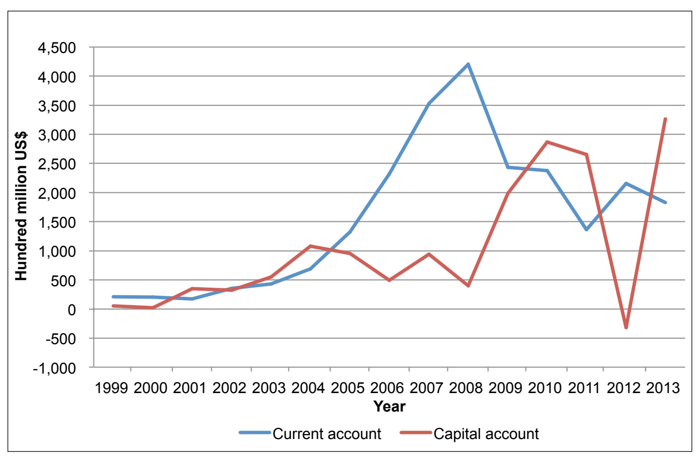
A recent study identifies 37 countries that have added the RMB to their official reserves since 2010. These "early adopters" are countries that share China's political preferences with regard to the international order (Liao and McDowell 2015). Presumably, beyond these countries, others will base their decision about holding RMB in their reserves on more conventional criteria — convertibility, credibility and liquidity.

Thus far, the Chinese currency faces significant limitations along all these dimensions. First, with regard to convertibility of the RMB, earlier this year the PBoC's Zhou (2015) stated: "According to the IMF's classification of capital account transactions, 35 out of the 40 items are fully or partly convertible in China, and only five items remain inconvertible. These five items mainly involve individual cross-border investment and the issuance of shares and other financial instruments by nonresidents on domestic markets. Therefore, China is not far from achieving its goal of RMB capital account convertibility." However, a closer look at China's rules and policies shows that the convertibility is far more limited than it is described to be. Even as many channels are opened and expanded for capital flow, the Chinese government maintains control over them through licensing, quota allocation and other forms of intervention. China's capital account liberalization so far has been quite different from conventional understanding of the term (Wildau 2015b).

Second, with regard to credibility, historically, reserve currencies have been issued by democratic polities. For instance, behind the sterling and the dollar were British and American institutions characterized by transparency, checks and balances, and rule of law. Going further back in time, other international currencies, such as the Dutch guilder, the Genoese denaro and the Venetian ducat, came out of republics or self-governing communes (Eichengreen and Kawai 2014; Cohen 2014; Germain and Schwartz 2015). If the RMB is to be an international reserve currency, people need to have a great deal of confidence in the institutions of China. They need assurance that if they are to hold their wealth in the RMB, it is safe from the arbitrary action of the government and will be protected by an independent central bank and a competent judicial system. Thus far, China's institutional set-up remains very different from these precedents. The tight grip of the government on the economy and the financial system, most recently highlighted by the heavy-handed intervention in the stock market this past summer, has not been conducive to confidence building. Even China's own rich and powerful have been shifting assets overseas on ever-larger scales, in part because of their lack of trust in the institutional protection of property in China.[9]

Third, with regard to liquidity, China is again in a position that is far from what is expected of a reserve currency issuer. For a country to provide liquidity to other countries using its own national currency, it has to have an overall balance of payments deficit. Since the mid-1990s, China has consistently run current account surpluses. Until recently, it has also maintained capital account surpluses (see Figure 1). Given the unlikely prospect of China running current account deficits in the foreseeable future, the alternative is for it to provide RMB liquidity to the rest of the world through capital account deficits. This might involve China's lending and investing abroad and providing aid using RMB. Indeed, the Chinese government has often described its recent financial outreach programs, such as the New Development Bank (NDB), the AIIB and the Silk Road Fund, as channels to promote the use of RMB for international investment. However, thus far, China's outgoing investment has been mostly conducted in US dollars. In other words, capital outflow from China has not yet become a major source of RMB liquidity. This is understandable given China's desire to diminish its massive foreign reserves held in dollar assets (Chovanec 2015).

Figure 1: China's Balance of Payments



Data source: State Administration of Foreign Exchanges.

8 Central banks will likely conduct their own studies and decide whether the RMB meets their own criteria for holding it in their reserves. Exchange with central bank officials, September 2015.

9 This phenomenon is also due to the fear of investigation and punishment on the part of many of the rich and powerful who have obtained their wealth through corruption.

Based on the discussion above, it seems reasonable to conclude that the RMB's status as an international reserve currency depends not so much on the IMF's acceptance of it into the SDR basket as on the underlying conditions of its convertibility, credibility and liquidity.

Although the IMF's decision to include the RMB in the SDR basket will not necessarily have any significant impact on the RMB's reserve currency status, it may well have a positive effect on China's financial reform. It is well known that China's accession to the World Trade Organization (WTO) was a calculated move on the part of market reformers in China. China implemented many difficult reforms in the pursuit of WTO membership. Once it became a member of the global trade body in 2001, many of the reforms introduced in the 1990s became "locked in," making the Chinese economic system much more transparent and liberal than before (Sally 2011). Similarly, as discussed above, China's reformers have pushed hard for financial liberalization in the name of making the RMB part of the SDR. Once the Chinese currency enters the SDR basket, it is likely to be a major bulwark against backsliding. Immediately after the IMF's meeting on November 30, the PBoC's Yi Gang warned that the RMB's entry into the SDR basket is "not once and for all" as the basket will be reviewed every five years. If the Chinese currency fails to meet the criteria, it will have to leave the basket. China must stay the course of financial reform in order to strengthen the RMB's position in the SDR basket (Xinhua 2015c).

Assuming China's financial reform will proceed in the years to come, it is possible that the RMB will, in time, become an international reserve currency. Being the issuing country of an international reserve currency has its advantages, as discussed earlier. Chinese policy makers and analysts have long been critical (and maybe envious) of the dominant role of the US dollar, arguing that it has given the United States exorbitant economic and political privileges. They see the continued reliance on the dollar as harmful to China's national interest in terms of financial losses, economic vulnerability and geopolitical constraints vis-à-vis the United States. Making China's own currency an international reserve currency will go a long way toward ameliorating these problems.

However, it is important for Chinese policy makers to recognize that there is a downside of being the issuer of a reserve currency (Dobbs et al. 2009; Subramanian 2011). For instance, the wide demand for the Chinese currency could lead to its secular appreciation, which will reduce the competitiveness of China's exports and, in turn, further slow down its economic growth. As trading in RMB-denominated assets grows, capital flow in and out of China will pose serious challenges to its financial stability. As the issuer of an international reserve currency, the Chinese government will be expected to consider the global implications of its macroeconomic policy, limiting the flexibility of its policy options.

Besides its impact on China, what implications does the RMB's entry into the SDR basket have for the international financial system? The limited space in this paper does not allow for a detailed discussion of this question, but it is useful to highlight three types of potential systemic implications.

First, the inclusion of the RMB is likely to boost the relevance of the SDR and stabilize its exchange rate. The SDR is a synthetic and symbolic currency. As the IMF states, "The currencies included in the basket should be representative of those used in international transactions.… The relative weights of the currencies included in the basket should reflect their relative importance in the world's trading and financial system" (IMF 2015b). Given China's growing share of the global economy and the increasing internationalization of its currency, adding the RMB to the SDR basket seems essential to ensure the relevance of the SDR. The IMF also states that "the SDR's value should be stable in terms of the major currencies. Wide fluctuations of the SDR exchange rate against the major global currencies, as occurred, for instance, during the period when the SDR was linked to the U.S. dollar, could undermine the SDR's attractiveness as a store of value" (ibid.). In light of the increasing flexibility in China's exchange rate regime, the movement of the RMB may become less tied to the US dollar over time. Including the RMB in the SDR basket will help minimize the fluctuations in the SDR's value against the major currencies.

Second, to the extent that the RMB's inclusion in the SDR basket represents a symbolic seal of approval of the Chinese currency as an international currency, it could help diversify reserve currencies (probably more gradually than the Chinese government aspires). Scholars and policy analysts have often pointed out the lack of sustainability and fairness of a dollar-based international reserve system (see, for example, Stiglitz 2006; Rodrik 2006). Since the global financial crisis, the call for reform has become even louder. If the RMB becomes a viable reserve currency — assuming continued financial liberalization in China — it will contribute to a movement away from the current heavy reliance on the US dollar as the world's reserve currency. In the long run, such diversification promises to expand international liquidity and improve the stability of the international financial system.

Third, the inclusion of the RMB in its SDR basket will help maintain the centrality of the IMF in global financial governance. As part of the post-World War II Bretton Woods system, the IMF has faced increasing challenges in recent years because of the power shift in the global economy. In 2010, the IMF approved a major overhaul of its quota allocations and governance to increase the influence of the emerging economies, but these reform measures have been delayed indefinitely due to the lack of support from US Congress. In part in response to the lack of progress in reforming the traditional multilateral institutions, China and other emerging economies have set up parallel minilateral institutions such as the NDB, the Contingent Reserve Arrangement and the AIIB (Wang 2015). It is in the interest of the IMF to overcome the inertia on voice reform and find other options to give China more recognition and a greater stake in the multilateral organization. Accepting the RMB in the SDR basket seems to be just such an option. As noted before, whether or not the RMB meets the criterion of "freely usable" is a controversial question. In the end, the IMF's decision has been a judgement call based on both political and technical considerations. In this case, what has been good for the IMF has been good for China and — potentially — good for the international financial system.

CONCLUSION

This policy paper has tried to shed light on China's recent efforts to have its currency included in the SDR basket. It explains China's interest in this seemingly exotic and technical question, identifying the political and economic motivations underlying this initiative. The paper discusses how and why China's bid has been a controversial issue for the international community and for Chinese policy circles, revealing the stakes for various actors. Lastly, the paper explores some plausible and implausible consequences of the RMB's inclusion in the SDR basket.

As this paper makes clear, the inclusion of the Chinese currency in the SDR basket does not in itself transform the RMB into a global reserve currency. The latter will involve a more protracted process, requiring serious institutional reforms in China. So far, Chinese policy makers have been taking a careful but determined approach toward that ultimate goal. Despite a slowdown in the country's economic growth and increased volatility in its financial market, they have accelerated financial reforms of late in the context of getting the Chinese currency into the SDR basket. By responding positively to the RMB's quest for SDR status, the international community is helping to maintain the reform momentum and to strengthen the reformers in China.

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