BANK FOR INTERNATIONAL SETTLEMENTS

The renminbi in the SDR basket and its future role in the international financial system

Speech by Mr Peter Zöllner[1]

Head of Banking Department, BIS

To 2016 MEFMI Governors' Forum

Dar Es Salaam, 20 June 2016

I would like to thank you for the invitation to come here and speak about the imminent inclusion of the renminbi in the SDR basket.

This debut represents an acknowledgment of China's remarkable success in opening up its markets, and it elevates the renminbi to the ranks of the most important international currencies.

I will approach this talk by first outlining some basic facts about the SDR and its origins. I will then move to an analysis of the major steps in the renminbi's progress towards becoming an international currency worthy of SDR status. Finally, I will discuss what inclusion in the basket means for the renminbi as a reserve currency. Here, I will also touch on how the BIS has been preparing for this change.

1. Introduction: the SDR

The SDR is a synthetic currency created in 1969 by the IMF. Its value was initially expressed in terms of gold, as it was conceived in a monetary system where the link between currencies and gold set limits on how far the growing demand for reserves could be met.

With the end of the Bretton Woods system in 1971, the SDR's composition changed to include the currencies of countries with the largest shares of exports of goods and services. From 1974, it comprised 16 currencies (the US dollar's weighting was 33%, a percentage already higher than the country's share of world exports), but in 1981 the synthetic currency was downsized to include just the G5 currencies, being the US dollar, Japanese yen, Deutsche mark, pound sterling and French franc. In 1999, the euro replaced the former European currencies, and the SDR became a four-currency basket.

As of 1 October 2016, the basket will be enlarged to include the renminbi as the fifth currency.

[1] I am grateful to Michela Scatigna for her excellent assistance with the drafting of this speech. The views expressed here are my own and not necessarily those of the Bank for International Settlements.

The SDR today not only plays its initial role as a composite alternative reserve asset. It has been occasionally used as a reference for various transactions undertaken by official institutions and it also has been adopted as unit of account by a number of official institutions,[2] including the BIS.

The weights and the composition of the currencies comprising the SDR are revised every five years by the IMF's Executive Board. These reviews determine the relative weights of each currency in the basket and establish which financial instruments should be used to calculate the SDR interest rate.

Even though discussions about the possible inclusion of the renminbi started as long ago as the 2010 Review, the Executive Board decided only last November that the Chinese currency would join the SDR as of 1 October.

This decision was based on the fulfilment of two broad criteria set by the IMF:

The first "gateway" criterion affirms that only the currencies issued by (member) countries or monetary unions with the largest value of exports over a period of five years can be considered. This criterion responds to a need to ensure that only currencies that play a significant role in the global economy can be considered for inclusion in the SDR.

The second criterion requires that the potential currency is "freely usable".

As described by the IMF, free usability refers to two main concepts. First, the currency must be widely used to make payments in international transactions. Additionally, the currency must be *widely traded* in the principal exchange markets, meaning that large amounts of currency can be traded at any time without significant change in the exchange rate (implying the need to be able to trade around the clock). In other words, each currency in the basket must have a broad and deep foreign exchange market, including for hedging.

The concept of "free usability" is different from both the free-floating and fully convertible concepts. A currency can indeed be free-floating but not freely usable (for example, the yen and the pound were considered freely usable even at times when some capital controls were in place). Likewise, a currency that is fully convertible might not be widely used or traded. The free usability criterion responds to the need that a member purchasing another member's currency from the IMF would be able to use it, both directly and indirectly (ie exchanging it into another currency) to meet its balance of payments needs.

2. The renminbi's road to the SDR basket: how did we get here?

The first aspect to consider when looking at the renminbi's path towards the SDR basket is China's extraordinary economic growth over the last 30 years.

No other country in modern history has achieved such high rates of growth for so long. From 1980 to 2010, China grew at an average rate of 10% every year. In terms of rankings, China is today the world's second largest economy (using GDP at market exchange rates), and when measured at purchasing power parity, it accounts for 17.1% of global GDP, surpassing the United States (15.8%), in 2015.[3]

---

2 These include the African Development Bank, the Arab Monetary Fund, the Asian Development Bank, the Bank for International Settlements, the Common Fund for Commodities, the East African Development Bank, the Economic Community of West African States, the International Centre for Settlement of Investment Disputes, the International Monetary Fund, the International Fund for Agricultural Development, and the Islamic Development Bank.

3 IMF, *World Economic Outlook*, April 2016 database.

This rapid growth was prompted by market-oriented reforms that opened the Chinese economy to the world. Two drivers are often cited as main factors behind this growth, namely exports and investment.

Chinese merchandise is everywhere in the world; someone in the audience is now probably holding a pen, or using a computer or wearing clothes that were produced in China. Some 13.8% of global trade originated in China in 2015, making it the largest exporter in the world (way ahead of the United States with 9.1% and Germany with 8.1%[4]).

The strong growth in investment and infrastructure is often cited as another of the main engines of China's growth during the 2000s. It is estimated that, during these years, capital accumulation accounted for more than half of average real growth.

Even though China's growth is currently slowing, as a new equilibrium is sought, there is very good reason to believe that the scale and the fundamentals of its economy make a strong case for the rise of the renminbi as an international reserve currency.

The second aspect that pushed the renminbi towards the SDR is the active role played by the Chinese government and central bank to promote the internationalisation of its currency.

Historically, no other currency has been pushed so actively by its authorities as a means of global exchange.[5]

In March 2009, China raised the issue of international monetary and financial system reform, leading Governor Zhou Xiaochuan of the People's Bank of China (PBoC) to bring to the discussion an increased role for the SDR in the international financial system. However appealing this idea may be, a more prominent role for the SDR remains more easily said than done. Yet the desirability of reform in the international monetary system is real, and it has been proposed on many occasions, as at the G20 Summit at Cannes in 2011.

In pursuit of more open financial markets, the Chinese authorities have taken a number of steps to encourage greater participation in the country's foreign exchange, bond and equity markets.

In what follows, I would now like to provide you with a very brief review of these steps and, more importantly, to give you an update of where things now stand.

Initiatives for public sector investors

As you may know, China entered into a number of swap agreements before the internationalisation of the renminbi was put on the agenda. In fact, in November 2000, after the Asian crisis, the ASEAN central banks agreed to set up bilateral swap agreements under the Chiang Mai Initiative, with the main aim of providing liquidity for short-term payment needs. Since 2009, the PBoC has actively pursued an expansion of *bilateral swap agreements* with central banks overseas (not only in the ASEAN region) with a view to increasing the use of the renminbi internationally. As of September 2015, 34 central banks have signed these agreements, with a total amount of roughly half a trillion dollars (RMB 3.16 trillion).

From 17 August 2010, foreign central banks, monetary authorities, Hong Kong SAR and Macau SAR RMB clearing banks, and foreign banks engaged in renminbi trade clearing have been allowed to invest in China's interbank bond market. These investments have several restrictions, but there is no minimum holding period.

---

4 WTO, "Trade growth to remain subdued in 2016 as uncertainties weigh on global demand", press release, www.wto.org/english/news_e/pres16_e/pr768_e.htm.

5 See J Frankel, "The rise of the renminbi as international currency: Historical precedents", VoxEU, 10 October 2011, http://voxeu.org/article/rise-renminbi-international-currency-historical-precedents.

Following these steps, access to the Chinese onshore interbank bond markets was further liberalised last summer. On 14 July 2015, the PBoC announced that foreign central banks, sovereign wealth funds and international financial institutions could now access the onshore interbank markets for bond, repo, IRS, and other permitted products after registering with the PBoC. As you know, many of the central banks, sovereign wealth funds and international financial institutions have previously accessed these markets through programmes such as China's Interbank Bond Market with an approved quota.

This step removed the quota system and requires only prior registration. Investors are also free to decide how much they want to invest. This will likely help broaden market access and improve participation onshore, marking another step toward capital account convertibility.

In a further effort to fully liberalise access by public sector investors[6] to the onshore Chinese FX market, the PBoC announced full liberalisation of FX trading in China's interbank FX market in September 2015. This means that public sector investors can access the interbank FX market through three channels, namely (i) using the PBoC itself as their agent, or (ii) by using interbank FX market members as their agent(s), or (iii) directly participating in the interbank FX market as foreign members.

Public sector entities can choose one or more channels from the above options and trade all FX products including spots, forwards, swaps and options through bilateral trading methods, without any quota restrictions.

Additionally, a couple of new procedures related to accessing both China's interbank bond market and China's foreign exchange market were issued by the PBoC in April this year.[7]

In the meantime, the PBoC has also been taking steps to open up access for private institutions to onshore FX and bond markets.

Initiatives for private sector investors

On 24 February 2016, the PBoC announced the opening of the onshore interbank bond market to foreign institutional investors. Qualified institutional investors were defined as financial institutions such as commercial banks, insurance companies, securities companies, fund and asset managers (and investment products issued by them), as well as pension funds and charity funds that (i) are incorporated outside China and in compliance with relevant regional laws; (ii) have not been subject to major penalties related to bond investments in the past three years; and (iii) have appropriate risk management controls. More importantly, the investments of these medium- and long-term investors on the interbank bond market will no longer be subject to quota limits, and the PBoC will supervise investment activity via macroprudential measures.

Based on the foregoing, it is clear that the Chinese authorities have chosen to open their financial markets gradually, initially encouraging public sector investors to gain access and then letting the private sector in. The greater number of measures undertaken during the last two years is likely to be related to the renminbi's imminent entry into the SDR and more such steps can be expected.

---

6 Including: foreign central banks, sovereign wealth funds and international financial institutions.

7 See PBoC, "Procedures for Foreign Central Banks and Similar Institutions to Enter China's Inter-bank Bond Market", April 2016, www.pbc.gov.cn/english/130721/3048181/2016041414393716593.pdf; and PBoC, "Procedures for Foreign Central Banks and Similar Institutions to Enter China's Inter-bank Foreign Exchange Market", April 2016, www.pbc.gov.cn/english/130721/3048181/2016041414393786728.pdf.

3. The renminbi's future role in the international financial system

All the steps described above have helped the renminbi to establish itself as an international currency, traded both on- and offshore in increasing volumes. In 2013, the renminbi was the ninth most traded foreign currency in the world[8] and by 2014, the fifth most used world payment currency in terms of volumes reported by SWIFT.

According to more recent data for offshore foreign exchange turnover in London, daily average turnover in renminbi more than doubled in the last two years (from $19 billion in April 2013 to $43 billion in April 2015).[9] Data for Hong Kong also show further growth there, with a daily turnover of $93 billion up by 88% from $49 billion in April 2013.

In terms of bond and equity markets, Chinese markets have reached a considerable size. However, in terms of turnover, these markets remain behind those belonging to the other four currencies in the SDR.

The presence of the renminbi in the portfolio of reserve managers remains more difficult to assess because of lack of data. The BIS Annual Report[10] last year guesstimated the share of foreign exchange reserves in renminbi at 1%, the IMF reported an even higher number of 1.1% in 2014, up from 0.7% in 2013.[11] For this year, most surveys expect this share to continue rising, to about 2%.

The renminbi's relevance in reserves managers' portfolios will evidently grow, even if the speed of that growth remains uncertain. This will be determined by a combination of domestic and international factors.

For the renminbi to develop the status of reserve currency, much will depend on whether and how the Chinese authorities will continue to open up their markets and modernise their market infrastructure. It is reasonable to expect that the liberalisation of the last few years will continue, allowing even greater access to the renminbi both offshore and onshore. As we have seen, significant steps have been taken to remove restrictions on investing in the renminbi. On top of this, the authorities are trying to promote the use of the renminbi indirectly through initiatives aimed at supporting the SDR, including a proposal to set up an SDR-denominated bond platform.[12]

Overall, it is possible that the renminbi's inclusion in the SDR will serve to continue or accelerate initiatives to support the currency. However, doubts still remain. The renminbi is still not fully convertible for capital account transactions. How and when capital controls will be removed will test the macroeconomic resilience of the Chinese economy to uncontrolled flows of funds. Additionally, the coexistence of two exchange rates for the renminbi, one for onshore (CNY) and one for offshore (CNH) transactions, still poses potential operational issues, especially at times when the divergence between these two rates widens.

---

8 See Bank for International Settlements, *Triennial Central Bank Survey of foreign exchange and derivatives market activity in 2013*, December 2013.

9 See the Semi-Annual FX Turnover Surveys published by The London Foreign Exchange Joint Standing Committee (FXJSC), October 2015.

10 See Bank for International Settlements, *85th Annual Report*, June 2015, p 85.

11 E Prasad, *China's efforts to expand the international use of the renminbi*, Report prepared for the US-China Economic and Security Review Commission, Brookings Institution, February 2016.

12 "China looking at ways to issue SDR bonds", Reuters, 1 April 2016.

Traditional reserve management practices for asset allocation of reserves follow the well known paradigm of safety, liquidity and return. In the case of the renminbi, it is safe to say that higher interest rates, along with appreciation expectations, has prompted a number of central banks to diversify a small fraction of their reserves into the Chinese currency.

The trend of diversifying into some of the major emerging market currencies has also supported this development. In line with that trend, African nations have also started to diversify into the renminbi. Since 2013, at least six African countries, namely Angola, Ghana, Kenya, Nigeria, South Africa and Tanzania, have publicly announced investments in renminbi-denominated assets. It goes without saying that the growing economic ties between Africa and China over the last decade have also played a role in promoting the renminbi's internationalisation in Africa.

The renminbi's arrival in the SDR basket will not mechanically drive a change in the currency allocation. Other currencies, such as the Canadian dollar and the Swiss franc, enjoy the status of reserve asset without being included in the SDR.

Moreover, even though the SDR was conceived with the idea of diversifying reserve allocations, it is still dominated by the dollar, with that currency's weight well above the weight of the others in the basket. In fact, the renminbi's share of the basket has been accommodated by a larger reduction in the weights of the euro and the pound (by 6.47 and 3.21 percentage points, respectively)[13] while the dollar's weight remains virtually unchanged (from 41.9% to 41.73%).

In part, this merely reflects the US dollar's bellwether role in reserves managers' portfolios since World War II.[14] Currently, the US dollar accounts for 60% of global foreign exchange reserves and for one side of almost 90% of all FX transactions.

Globally, demand for dollars is still strong, even after the financial crisis. Indeed, demand for dollars was even stronger during those stressful times.

Among other criteria, an international reserve currency is a currency backed by a big economy with highly developed capital markets, a currency that investors can "trust," especially during periods of stress. "Trust" means that the behaviour of the forces governing the movements in that currency are mostly predictable and determined by market forces.

The BIS and the SDR

To conclude, I would like to turn to the role of the SDR for the BIS, and the Bank's involvement in the renminbi market.

Let me begin this last part by saying that – for the BIS – the SDR has been the unit of account since 2003 when it replaced the so-called gold franc.

Furthermore, official institutions are relying on us to provide banking products and services in SDR as well as in all its basket currencies.

From this, it becomes clear that the BIS is undertaking significant efforts to prepare for a smooth switchover to the new SDR basket. We have, for example, acquired direct access to the CNY FX market by installing a trading terminal a few months ago. We are updating our systems, reviewing our procedures and extending our product range.

---

[13] The current weights are as follows: USD (41.9%), EUR (37.4%), JPY (9.4%), GBP (11.3%). As of October 2016, the new weights will be: USD (41.73%), EUR (30.93%), JPY (8.33%), GBP (8.09%), RMB (10.92%).

[14] For more on the dollar supplanting the role of sterling, see B Eichengreen and M Flandreau, "The Federal Reserve, the Bank of England, and the rise of the dollar as an international currency, 1914–1939", *BIS Working Papers*, no 328, November 2010.

In this endeavour, we are profiting from the continuous dialogue with our customers, from the tremendous support of the People's Bank of China, from our regional Representative Office in Hong Kong SAR, opened in 1998, and – not least – from our lengthy experience in both the onshore and in the offshore renminbi markets.

For a number of years, the BIS has been investing in the renminbi onshore and offshore markets and has provided customer services in CNH.

In 2004, we started engaging in the Chinese fixed income market as the administrator of the Asian Bond Fund 2, an investment fund launched by the EMEAP central banks which invests in the domestic currency bonds of eight Asia-Pacific markets, including China.

In 2012, the BIS acquired a quota for the onshore renminbi market and started proprietary investments in the CNY.

Our first CNY product was a BIS Investment Fund invested in CNY government securities, which we launched in March 2014 at the specific request of a number of central banks. As of today, 23 institutions from the Americas, Asia-Pacific, Europe and Africa are invested in the fund.

Recently, we have started providing foreign exchange services in CNY, with CNY sight accounts and deposits to follow. We see the rising importance of the renminbi for reserves managers worldwide reflected in the strength of customer demand for these products – a demand that the BIS will do its utmost to meet, committed as we are to accommodating the full range of evolving central bank requirements.