Adding RMB into the SDR Basket: Implications, Prospects and Approaches

Research Team on International Monetary System[1]

Shanghai Development Research Foundation

Special Drawing Right (SDR) is an unavoidable issue in the current discussion of the international monetary system (IMS) reform no matter whether you are in favor of enhancing the role of the SDR. The International Monetary Fund (IMF) created the SDR in 1969 as a supplement to international reserves so as to resolve liquidity problems in the IMS. In accordance with Articles of Agreement of the International Monetary Fund, one of IMF's objectives is to make SDR the principal reserve asset in the IMS[2]. Although the SDR hasn't achieved this particular objective satisfactorily in the past four decades, the role of the SDR in the IMS should not be ignored any more after the 2008 financial crisis. We proposed that the status and role of the SDR should be enhanced in the IMS in a recent research. Although it takes a long time to make the SDR a global reserve currency (Shanghai Development Research Foundation, 2011), promoting steadily the use of the SDR from now on will be conducive to creating a healthy IMS.

Another issue of international concern is whether the currencies of emerging market countries, especially RMB, should be included in the

[1] Team chairs: Yide Qiao, Secretary General, Shanghai Development Research Foundation; Mingqi Xu, Deputy Director, Institute of World Economy, Shanghai Academy of Social Sciences. Major members: Rui Li, School of International and Diplomatic Affairs, Shanghai International Studies University; Qing Shi, College of International Finance and Commerce, Shanghai International Studies University; Jiafei Ge, Institute of World Economy, Shanghai Academy of Social Sciences.

[2] See *Articles of Agreement of the International Monetary Fund, Article VII Section 7 and Article XXII.*

SDR basket. Whether the SDR should include RMB was a heated and controversial topic on the G20 conference on the international monetary system in Nanjing in March, 2011. In the previous research mentioned above, we designed the action plan of strengthening SDRs and reforming the governance structure of the IMF to provide a comparatively detailed timetable for the IMS reform in a 15-year time horizon. In the action plan, we proposed that the IMF should consider including the currencies of emerging market countries in the SDR basket and adjust the currency weights of the SDR basket according to the economic situation in the next two to six years (2012-2016) (Shanghai Development Research Foundation, 2011). We put forward the proposal in view of the fact that the IMF's next review of the valuation of the SDR will be in 2015 and it is pressing and pertinent to make further research on the issue.

Based on the judgment mentioned above, this report tries to answer the following questions: What are the implications for the IMS and China if RMB is included in the SDR basket? Is RMB qualified to join the SDR basket in the foreseeable future? What challenges will China face? What should China do?

1. Implications: conducive to creating an improved international monetary system

In view of the fact that China has become the second largest economy in 2010 with its high speed and potential of economic development, RMB has the potential to be a polar of multi-currency reserve system and has the ability to share the responsibility for maintaining the IMS stability. The inclusion of RMB into the SDR basket will exert far-reaching influence over the IMS reform and China itself.

1.1. To make the SDR more inclusive and representative

All four currencies in the SDR basket, including the U.S. dollar, the

Euro, the pound sterling and the Japanese yen, are developed countires' currencies. These contries' GDP accounts for only 55.4% of world GDP[3]. Although the current SDR basket enjoys certain advantages in terms of easy calculation, it is necessary to make the SDR more representatives in order to enhance the role of the SDR in the IMS. The current basket composition does not reflect the fact that emerging countries are playing an increasingly important role in global economic and financial pattern. Therefore, it is urgent to make the SDR basket more inclusive and representative. If RMB becomes a SDR basket currency, the basket-currency issuing countries will account for 64.7% of world GDP, which will improve the representativeness of the SDR to a certain extent. Meanwhile, as one of the largest emerging economies, China's promotion of RMB into the SDR basket will generate a demonstration effect for other emerging countries and open up an approach for other emerging-country currencies' inclusion in the SDR basket. If the SDR basket includes the currencies of the BRIC, the basket-currency issuing countries will account for 73.2% of world GDP, which will make the SDR more inclusive and representative.

1.2. To stabilize the value of the SDR with the non-synchronization of economic cycle of developed economies and emerging economies

Non-synchronization is the asynchronism of economic fluctuations of cycle among different countries. Qin, Le and Bu (2002) calculated the correlation coefficients of periodic fluctuations between China and the United States, China and Japan and found 0.145 and -0.254 respectively. In other words, China's economic cycle does not recede or boom synchronously with United States and Japan. The imbalanced post-crisis

[3] Data source：IMF and WEO Database, calculated by SDRF, similarly hereinafter.

recovery also reflects an obvious non-synchronization of economic cycles between developed economies and emerging economies.

Modern Portfolio Theory indicates that the inclusion of weakly-correlated or negatively-correlated assets reduces the fluctuations of the value of portfolio. It enlightens us that the value of the SDR will be more stable if the SDR basket currencies are weakly correlated. The current SDR basket comprises entirely currencies of developed economies, without any currencies from emerging economies. In times of financial crises, the developed countries tend to have convergent economic trends and their currencies tend to move synchronously; therefore, the value of the SDR tends to be unstable if the basket includes only currencies of developed economies. The non-synchronization of emerging economies and developed industrial economies as well as the different trends of their currencies will help to stabilize the value of the SDR if emerging economies' currencies, such as RMB, are included in the SDR basket. Yi, deputy governor of the People's Bank of China, verified the viewpoint mentioned above in his recent research. Yi examined the candidates for the SDR basket in accordance with the current regulations and rules and structured a shadow SDR with 8 currencies including the current basket currencies and the BRIC currencies. He stimulated and calculated the value of the shadow SDR in the period of January 2005–November 2010 and compared it with the current SDR. He found that the standard deviation of the current SDR exchange rate was 0.05584 and that of the shadow SDR was 0.05503, a little smaller than the former. Therefore, he concluded that the inclusion of the BRIC currencies in the SDR basket would strengthen the stability of the SDR (Yi, 2011).

1.3. To enhance the role of the SDR as a international reserve

Although the flaw of the current unipolar dollar-dominant IMS has already been recognized by the international community, there remains much controversy over the IMS reform scheme. Since it is now difficult to revive an IMS with gold standard or create a super-sovereign currency reserve system in a short term, an ideal approach to eliminate the inherent instability in the unipolar IMS is to improve current managed multi-currency reserve system to reach a state of equilibrium among key currencies including the SDR and currencies issued by main economies (Shanghai Development Research Foundation, 2011).

RMB into the SDR basket will enhance the attractiveness of the SDR as an international reserve worldwide. Now, the amount of cross border settlement in RMB is growing quickly; many foreign exchange reserve management institutions, such as central banks and sovereign wealth funds, are willing to hold RMB because of their positive expectations towards the prospects of China's economic development, but they do not have enough sources to get RMB because RMB is not fully convertible under the capital account. The acceptance of RMB by the international community has been improved substantially. If RMB becomes one of the SDR basket currencies, the institutions' willingness to hold RMB assets will increase Because that holding more SDRs will be equivalent to hold the share of RMB in the reserve portfolio indirectly. The increasing demand for SDRs is conducive to improving the role of the SDR as a reserve currency, which is especially important if the role of the SDR has been enhanced in the IMS.

1.4. To further promote China's capital account opening

Basically speaking, opening the capital account promotes RMB to be accepted into the SDR basket; on the other hand, getting RMB into the SDR basket is conducive to further opening China's capital account.

China's reform and opening-up has made remarkable achievements, especially the measures in financial industry have created a good institutional environment for the internationalization of RMB. Including RMB into the SDR basket will promote China to open up further capital account. RMB has become convertible under the current account since December, 1996. Since then, capital account convertibility has also been promoted steadily. Capital account can be divided into 7 classes, 40 items in accordance with the IMF definition. In China, 5 items are fully convertible, 8 items mainly convertible, 17 items partly convertible and 10 items not convertible. In other words, more than 75% of the items are at least partly convertible[4]. RMB is getting close to full convertibility. The negotiation progress and the possible inclusion of RMB in the SDR basket both demand that more items of the capital account should be opened and RMB become fully convertible. Opening up orderly and stably will not only consolidate the achievements of financial opening-up but also promote RMB to be a real international currency and share the responsibility of maintaining the stability of the IMS.

1.5. To be conducive to promoting the internationalization of RMB

The currency internationalization is a dynamic process of extending partly or entirely the functions of a currency (including valuation, circulation, payment, store of value, etc.) from domestic area to neighboring countries or areas and even the whole world and becoming an international currency (Liu and Xu, 2006). Since the 2008 financial crisis, the internationalization of RMB has been accelerated obviously and RMB is accepted by an increasing number of countries as a settlement currency in the international trade, as a store of value in

[4] See the remark of Li Chao, Deputy Director-General of SAFE, on the "1st China's Trade and Financing Forum" on Apr. 26, 2011. http://kuaixun.stcn.com/content/2011-04/27/content_2565734.htm

investments and even as a reserve currency by some sovereign states. The measures taken by the Chinese government to expand the offshore RMB business from the second half of 2010 indicated that the internationalization of RMB has become an increasing important goal of the Chinese government.

No doubt, the internationalization of RMB cannot be reached at one step. It is a dynamically developing process. The inclusion of RMB in the SDR basket will be a driving force for the internationalization of RMB. The SDR, as a reserve asset and the unit of account created by the IMF, is more acceptable than RMB that is not yet fully convertible in terms of l convenience. With the worldwide acceptance of the SDR as a unit of value, a medium of exchange, a means of payment and a store of value, being included in the SDR basket, RMB will be accepted as same as SDR internationally. Its function of international settlement, international credit and international reserve is expected to be improved. The role of RMB in the future IMS will be enhanced and China will have a better voice in the international economic and financial matters, which is one of the goals of Chinese government to promote the internationalization of RMB.

2. Prospects: RMB Expected to be included in the SDR basket in IMF's 2015 review

The value of the SDR is defined as a basket of currencies and the SDR basket composition is reviewed every five years.[5] Whether RMB is qualified to be included in the SDR basket when IMF review again in 2015, can be analyzed in accordance with the IMF's criteria, the evolution of the SDR basket and the current situation and prospects of

[5] The IMF reviews the valuation of the SDR every five years and prepares *Review of the Method of Valuation of the SDR*, which reviews the valuation of the SDR, the selection and weighting of currencies in the SDR basket, the SDR interest rate etc.

RMB.

2.1. The current criteria and evolution of the SDR basket currencies

2.1.1. The current criteria of the SDR basket currencies

In accordance with the IMF's criteria, "the composition of the SDR basket reflects the following criteria: the SDR basket comprises currencies that are issued by Fund members (or by monetary unions that include Fund members), whose exports of goods and services during the five-year period ending 12 months before the effective date of the revision had the largest value, and that have been determined by the Fund to be freely usable currencies" (IMF, 2010). (See Appendix 1 The Analysis of the Criteria of the SDR Basket Currencies.)

In accordance with Articles of Agreement of the International Monetary Fund, Article XXX (f), "a freely usable currency means a member's currency that the Fund determines is, in fact, widely used to make payments for international transactions, and is widely traded in the principal exchange markets." The IMF provides more detailed criteria for determining which currencies are freely usable: "the assessment of the use of a currency for international transactions should be based on the extent to which trade in goods and services is paid for in that currency, as well as on the relative volume of capital transactions denominated in that currency. Given the limited data availability, however, the staff suggested to use the shares in members' exports of goods and services and the currency denomination of official reserve holdings as the relevant indicators of the degree to which a currency was widely used in international payments; the assessment of whether a currency was widely traded in the principal foreign exchange markets should be based on the volume of transactions, the existence of forward markets, and the spread between buying and selling quotations for transactions denominated in that currency. A sufficiently deep and broad foreign exchange market was considered as being necessary to ensure that a member country would be able to sell or buy a sizable amount of the currency. ” (IMF, 2010) In accordance with By-laws, Rules and Regulations of the International Monetary Fund,O-3, “The Fund shall determine the currencies that are freely usable in accordance with Article XXX(f).” and “The Fund shall consult a member before placing its currency on, or removing it from, the list of freely usable currencies.” The current criteria reflects that the SDR basket currencies should be both representative in the international trade system and the international financial system, which means they should be widely used in both international trade and finance.

2.1.2. The evolution of the SDR basket currencies

The valuation of the SDR has been changed several times since the SDR was created in 1969. The value of the SDR was initially defined as equivalent to 0.888671 grams of fine gold, which, at the time, was also equivalent to one U.S. dollar (IMF, 2010). After the collapse of the Bretton Woods system, the IMF announced in 1974 that the SDR was no longer pegged to gold but redefined as a basket of currencies. At that time, the SDR basket included 16 currencies, each issuing country accounted for more than one percent of world exports of goods and services during the five-year period ending 1972. In 1980, the IMF redefined the valuation of the SDR and reduced the basket currencies to 5 principal freely usable currencies. From then on, the IMF has reviewed the composition and weights of the SDR basket currencies every five years. In 1981 to 1985, the SDR basket currencies were the U.S. dollar, the Deutsche mark, the Japanese yen, the French franc and the pound sterling.

Since its issuance in European Union in 1999, the Euro has replaced the Deutsche mark and the French franc as a basket currency. Meanwhile, currencies issued by monetary union have been included in freely usable currencies. From then on, the SDR basket has been composed of the U.S. dollar, the Euro, the Japanese yen and the pound sterling. (See Appendix 2 SDR Valuation Basket: Percentage Weights at Inception of Period (1981-2015).)

The history of the SDR basket shows that the component and weights of the SDR basket currencies reflect and be subject to the development and change of the world economic pattern. The current SDR basket and its criteria are formed because of historical reasons; however, the criteria for determining the SDR basket currencies are flexible, leaving room for interpretation instead of being unchanged. For instance, the component currencies were initially chosen according to the exports of goods and services and now they are determined from trade and finance perspectives; the number of component currencies reduced from 16 to 4. In addition, some of the criteria should be improved to better satisfy the need of world economic development. For instance, the IMF plans to consider whether a new SDR basket currency would be added to the basket or would replace an existing currency in the follow-up work.

2.2. The possibility of including RMB in the SDR basket

While the emerging markets gradually increase their share of the world economy, the existing SDR basket currencies (i.e. the U.S. dollar, the Euro, the Japanese yen and the pound sterling) issuers decrease their share, and will further decrease in the foreseeable future. Therefore, the current SDR basket is getting fewer representatives in the world economy. Including the emerging market currencies in the SDR basket will improve the structure of the basket and make it more representative to objectively reflect the current situation of the world economic structure. If we take the economic aggregate of countries into consideration, RMB is closest to the criteria for the IMF to include a currency into the SDR basket among the potential component currencies from emerging markets.

2.2.1. Full convertibility is not the prerequisite to join the SDR basket.

It is mistakenly to think that freely usable currencies should be fully convertible, thus claiming that being fully convertible should be a prerequisite for including RMB in the SDR basket. Geithner, the U.S. Treasury Secretary, said that the SDR-basket-currency issuing countries "should have flexible exchange rate systems, independent central banks, and permit the free movement of capital flows" (Geithner, 2011). Kudrin, the Russian finance minister, believed if RMB would be included in the SDR basket as a non-fully-convertible currency, it was just an exception; and China should provide a clear timetable to show when RMB would be fully convertible[6]. Compared with the rules and articles of the IMF, the concept of "freely usable" is misunderstood and people tend to confuse the concept of "freely usable" and "fully convertible". The IMF has clearly stated that "the concept of a freely usable currency concerns the actual international use and trading of currencies, and is distinct from whether a currency is either freely floating or fully convertible" (IMF, 2010). In fact, opening the capital account is not required in Articles of Agreement of the International Monetary Fund. In practice, when Japanese Yen was included in the SDR basket as a freely usable currency, it was not really fully convertible[7]. Therefore, that full convertibility should not be a prerequisite for including RMB in the SDR basket, and this kind of exclaim does not conform to the current criteria of the IMF

[6] Remarks by Kudrin, the Russian Finance Minister, during the group seminar on G20 conference in Nanjing.

[7] In December 1980, the Japanese government revised *Foreign Exchange Law*, transferring the convertibility principle of Japanese yen's capital account from restrictive convertibility to releasing control.

and should not be an obstacle in the way of getting RMB into the SDR basket.

2.2.2. RMB meets the criterion of "leading exporters" for the inclusion of a currency in the SDR basket

In accordance with the IMF's current criteria for the inclusion of a currency in the SDR basket, RMB meets the first criterion, i.e., China has been on the list of top exporters of goods and services during past five-year-period. In Review of the Method of Valuation of the SDR of 2005, the IMF already noticed China's fast economic development. China's exports of goods and services8 surpassed that of Japan's in 2003 and China became the fourth largest exporter, next to the Euro area, the United States and the United Kingdom. During the period of 2005-2009, China's exports of goods and services[9] remained the third, next to the Euro area and the United States. In addition, under the current economic climate, China's status as a leading exporter will continue to grow steadily. Therefore, RMB meets one of the criteria for the inclusion of a currency in the SDR basket, i.e., RMB's issuing country China has become one of the leading exporters. That's why RMB would be a candidate for inclusion in the SDR basket and the IMF used a lot of space in Review of the Method of Valuation of the SDR of 2010 discussing whether RMB would meet the criteria for the inclusion in the SDR basket.

2.2.3. There is a gap between RMB and a "freely usable currency"

Whether RMB will be included in the SDR basket mainly depends on whether RMB meets the criteria to be a freely usable currency. In accordance with Articles of Agreement of the International Monetary

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[8] Including Hong Kong SAR.

[9] Including Hong Kong SAR and Macau SAR. In *Review of the Method of Valuation of the SDR* of 2010, the IMF stated that even if exports of Mainland China alone are considered, China would remain among the top four exporters.

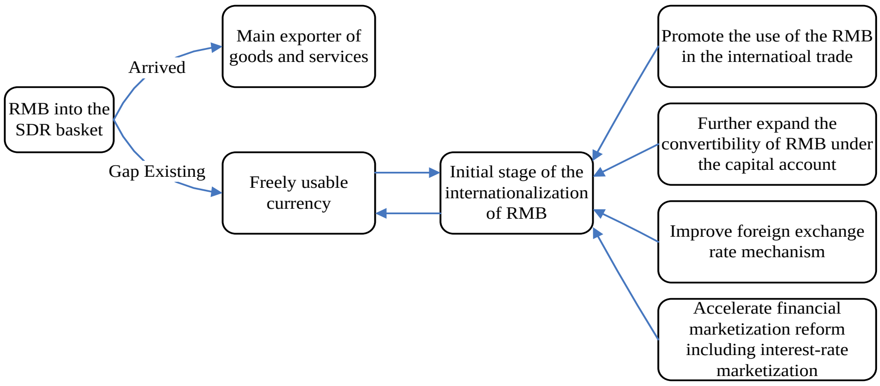
Fund, a freely usable currency is widely used to make payments for international transactions and is widely traded in the principal exchange markets. At the current stage, there is a gap between RMB and a freely usable currency, mainly because RMB is not widely used in international financial transactions. RMB is less than 0.2% of the international official reserve holdings. RMB accounts for 0.19% of international banking liabilities (Yi, 2011). Only 0.06% international debt securities were denominated in RMB between June 2005 and 2009. RMB transactions were only 0.1 percent of total turnover in global foreign exchange markets during 2007 to 2010 (IMF, 2010). The RMB turnover is relatively small compared with its import and export activities. For instance, in 2009 the ratio of annualized RMB turnover in foreign exchange market to international trade (exports plus imports) was 3.0, while the ratio for the Hong Kong dollar was 30.9 and for the US dollar was 270.0 (Chen & Cheung, 2011). In the 2010 review, the IMF points out that the Chinese government has made efforts to facilitate the international use of RMB; however, at this stage, RMB is not yet widely used to make payments for international transactions, or widely traded in the principal exchange markets, so RMB would not appear to meet the criteria under the Articles of Agreement for being determined by the Fund to be a freely usable currency and would not be included in the SDR basket (IMF, 2010).

However, RMB is getting closer to the criteria of freely usable currencies. In recent years, the Chinese government has taken a number of measures to facilitate the international use of RMB, including promoting cross-border settlement in RMB, promoting the People's Bank of China signing currency swap agreement with other central banks, allowing banks outside Mainland China to enter Mainland's interbank markets, allowing institutions outside Mainland China to issue RMB-denominated bonds in Mainland China, allowing institutions in Mainland China to issue bonds outside Mainland China etc. With an appropriate economic base, reasonable policies, and steady promotion from the government, RMB will be internationalized substantially and will meet the criteria of freely usable currencies in the foreseeable future. In 2015 review, it will be promising for RMB to be determined by the IMF as a freely usable currency and to be included in the SDR basket.

3. Approaches: Implement a package of policy measures focusing on the internationalization of RMB

As discussed above, RMB is expected to be included in the SDR basket in the near future, and there is still a gap between RMB and a "freely usable currency". In order to help RMB meet the criteria for the inclusion in the SDR basket, we need to make corresponding efforts. The main approach is to implement a package of policy measures focusing on the internationalization of RMB. RMB becoming a "freely usable currency" is the initial stage of the internationalization of RMB, and eliminating the gap between the two and deepening the process of the internationalization of RMB are not mutually exclusive. According to the arrangement of the IMF, the next review of the SDR basket will be in 2015. The review period will be the five years before the 2015 review, i.e. 2010 to 2014. The time leaving us to make RMB qualified to join the SDR basket is pressing, less than 4 years from now by strict calculation. In the next 4 years, we can implement the package of policy measures as follows (See Figure 1: Implement a package of policy measures focusing on the internationalization of RMB):

Figure 1: Implement a package of policy measures focusing on the internationalization of RMB



3.1. Promote the RMB denomination in the international trade

3.1.1. Expand the scope of RMB-denomination in bilateral trade

In accordance with the IMF's criteria for the inclusion of a currency in the SDR basket, currency issuing countries should be leading exporters of goods and services and currencies should be "freely usable". First of all, a freely usable currency means the currency is widely used to make payments for international transaction. China has surpassed Germany in 2009 and has become the largest goods exporter[10] and the third largest goods and services exporter[11]. However, the U.S. dollar is widely used in China's trade, while RMB is only used in rare cases. To make RMB a freely usable currency, we need to expand the scope of bilateral trade denominated by RMB and further expand the use of RMB in international trade settlement.

Signing cooperation agreement of RMB-denominated bilateral trade with more countries is an effective measure to expand the scope of bilateral trade denominated by RMB. China has begun to promote RMB denomination in bilateral trade. The volume of RMB in cross-border

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[10] Data source: WTO International trade and tariff data, 2010.

[11] Data source: WTO International trade and tariff data 2010, calculated by SDRF.

trade settlements has continued to increase since 2009 and reaches 530 billion yuan in April, 2011, which surpasses that of last year, reaching 5% of the volume of trade during the same period[12]. This figure is expected to rise to 15-20% (Yi, 2011). HSBC's latest survey of more than 6,000 trade companies in 21 countries shows that in Mainland China this year RMB is expected to exceed the Euro and become the second choice for enterprises as a settlement currency, second only to the U.S. dollar. This means in the next six months, RMB will exceed the pound sterling and become one of the three major settlement currencies by global trading enterprises for the first time[13].

3.1.2. Participate in regional multilateral financial cooperative mechanism and establish currency swap relationship with more countries

In practice, IMF regards the amount of exports of goods and services and the currency denomination in official reserve holdings of a member country as the relevant indicators of the degree to which a currency was widely used in international payments (IMF, 2010).However, RMB is not fully accepted as a reserve currency. It is important to promote bilateral and multilateral swap with more counties. By doing so, RMB will become part of foreign reserve for these countries and enhance the potential function of reserve currency of RMB.

In recent years, swap agreements denominated by RMB have made progress besides the promotion of the multilateral financial cooperative mechanism of ASEAN 10+3. The People's Bank of China signed the bilateral currency swap agreement of amount of RMB 3.5 billion, RMB 150 billion and RMB 25 billion respectively with the Central Bank of Iceland, Monetary Authority of Singapore and the Reserve Bank of New

[12] See the remark of LI Bo, director general of monetary policy department II, PBOC, about "Facilitating and Accelerating RMB's Cross-Border Flow" on May 19, 2011. http://sh.eastday.com/2011ljz/fhc/pjyh3/index.html
[13] See http://finance.cb.com.cn/13531828/20110505/205445.html.

Zealand on June 9, 2010, July 23, 2010 and April 18, 2011. Up to now, the People's Bank of China has signed nine currency swap agreements with other countries, and the size of bilateral currency swap agreement has reached 828.5 billion yuan[14]. More and more countries or regions are willing to hold or purchase RMB-denominated assets. The People's Bank of China has signed currency swap agreements with many central banks or monetary authorities. Korea is planning to buy RMB-denominated bonds. Financial institutions outside Mainland China are beginning to absorb RMB deposit. The RMB deposit in Hong Kong reached 314.94 billion yuan by the end of 2010 (PBOC, 2011). It is expected that more and more countries and regions will hold or be willing to hold RMB assets in 2015.

3.2. Further expand the convertibility of RMB under the capital account

As mentioned above, being fully convertible should not be a prerequisite for including RMB in the SDR basket. However, it does not mean that the convertibility of RMB is not a matter. It should be recognized that with the rising level of internationalization, any fully internationalized currency should be fully convertible under both current account and capital account.

3.2.1. Deepen the process of RMB's full convertibility under the capital account

Freely usable criteria for the inclusion of a currency into the SDR basket requires instantly the existence of forward market of this currency. In addition, full convertibility under the capital account is a fundamental

[14] Besides the currency swap agreements mentioned above, other six bilateral currency swap agreements signed by the People's Bank of China respectively are Bank of Korea, RMB 180 billion, December 12, 2008; Hong Kong Monetary Authority, RMB 200 billion, January 20, 2009; Bank Negara Malaysia, RMB 80 billion, February 8, 2009; National Bank of the Republic of Belarus, RMB 20 billion, March 11, 2009; Bank Indonesia, RMB 100 billion, March 23, 2009; Central Bank of Argentina, RMB 70 billion, April 2, 2009. Data source: PBOC.

measure of promoting RMB to be a fully convertible currency, improving the attractiveness of RMB as a settlement currency in international trade and a denominating currency in financial transaction and expanding the RMB foreign exchange market. Among the items of capital account, China now maintains strict control on the ones of borrowing foreign debt, cross-border securities investment, loans and direct investment by Chinese-funded firms. Although there is no exact timetable for the convertibility of RMB under capital account, China already has the four preconditions to realize full convertibility under capital account, i.e. macroeconomic stability, sound financial regulation, adequate foreign exchange reserves and strong financial institutions[15]. About ten years ago, Chinese scholars once formed some comparatively consistent views on the sequence of opening the capital account, which is liberalizing long-term capital flow before short-term capital flow, direct investment before securities investment, capital transaction before foreign exchange transaction, and residents' trading outside the country before non-residents' trading inside the country (Jiang, 1999; Zhang, 2000; Zhang, 2003). With the deepening of China's capital account opening, these theoretical classifications have become blurred. Now the key point of the policy is to determine the sequence of opening the items one by one under the capital account (Dong et al, 2010).

Of course, there are certain risks in the process of promoting RMB's convertibility under the capital account. The convertibility of RMB in capital account will increase the possibility of exposing the domestic economy to external shocks. That China could successfully resist the Asian financial crisis and the 2008 financial crisis, escaping direct impact of recession, was not just due to China's economy being more stable than

[15] See the remark of Xie Ping in the seminar of China Society for Finance and Banking on Apr. 20, 2011. http://www.caijing.com.cn/2011-05-09/110713303.html.

that of the countries in Southeast Asia or the United States and Europe. The economic upswing equipped China with a strong ability to withstand risks, the controls on capital account also contributed to resisting the two crises. Financial liberalization and globalization do provide opportunities for international short-term capitals to arbitrage, hedge or speculate. The full convertibility of RMB will increase the scale and speed of capital flows, and then bring about uncertainty to China's economic development and financial market stability; therefore, it is essential to speed up the the reform and development of financial market and the economy as a whole.

3.2.2. Further open onshore financial market

It is important to widen the investment channels in RMB assets in order to promote the internationalization of RMB. By the end of 2010, the investment quotas of QFII and QDII reached US$19.72 billion and US$69.661 billion in total[16]. In the current framework of QFII and QDII, expanding the scale and lessening the limit on investment are conducive to realizing the function of RMB as an investment asset and reserve currency. Meanwhile, allowing issuance of RMB-denominated stocks and bonds by qualified foreign institutions in China will increase other countries' interest in holding and using RMB, conducive to expanding the scope of denomination and settlement by RMB.

3.3. Reduce the central bank's intervention in foreign exchange market and improve foreign exchange rate mechanism

Although there is no direct causal relationship between exchange rate marketization and the internationalization of a currency, the comparatively strict control on exchange rate by the People's bank of China results in a strong one-side expectation on RMB appreciation, which causes asymmetry on buyers and sellers and hinders the use of

[16] Data source: SAFE.

RMB in bilateral trade. Therefore, the smooth development of the foreign exchange marketization reform will improve the financial efficiency, further straighten out the domestic price mechanism, and balance the use of resources at home and abroad, thus expanding the circulation and use of RMB outside Mainland China.

3.3.1. Further promote the marketization reform of the RMB exchange regime

In order to make RMB to be accepted in the SDR basket and contributes a positive impact, China should adopt a more flexible exchange rate regime instead of pegging RMB to the U.S. dollar to some extent; otherwise, including RMB into the SDR basket is equivalent to increasing the share of the U.S. dollar in the SDR basket. Meanwhile, the two-way floating of RMB is also imperative for RMB denomination and settlement in international trade. Although the People's Bank of China has launched two rounds of exchange regime reform, in fact, the central bank still intervenes RMB exchange rate and RMB hasn't entirely de-pegged to the U.S. dollar, the predominant reserve currency in the world.

Accelerating the marketization reform of RMB exchange regime may lead to risks and challenges from two aspects. First, it may exacerbate exchange rate fluctuation. Releasing the control on RMB exchange rate is bound to cause frequent fluctuations in its exchange rate. The international community holds strong one-side expectations on RMB appreciation; releasing the control on RMB exchange rate may lead to hot money speculation in RMB, causing massive fluctuations in RMB exchange rate. Second, domestic enterprises need to improve their ability in managing foreign exchange risks. China used to have a long-standing export-oriented fixed exchange rate regime pegged to the U.S. dollar, which means the Chinese government took all the foreign exchange risks. Most of the export-oriented private enterprises are weak, lacking the ability to manage foreign exchange risk. Even large state-owned enterprises are not experienced in managing foreign exchange risk. If the RMB exchange rate is allowed to float in a wider margin, it will bring certain shocks to the domestic enterprises.

3.3.2. Increase the breadth and depth of the overseas RMB markets

Since 2009, China has achieved substantial progress in the internationalization of RMB. In the offshore market, Singapore and Hong Kong have witnessed brisk Non-Deliverable Forward transactions; the size of RMB cash note exchange service has grown rapidly in Southeast Asia, the United States and some European countries (Yi, 2011). However, there are some new problems. RMB is likely to confront a “roundabout trap” in the process of “flowing out of Mainland China-circulating overseas-flowing back to Mainland China” (Li, 2011). Li argues that if we solely rely on the backflow of RMB to increase the return on investment in RMB and improve the will of overseas RMB holdings, the international circulation of RMB is only an internal cycle, i.e., the currency flows out and then flows back. Under such circumstance, the increase in the size of RMB outflow does not reflect the acceptance of RMB in the international community but reflects high return on investment in Mainland China and the attempt to hold high return RMB assets outside Mainland China. The simple circulation is not conducive to expanding the scope of using RMB internationally nor to deepening the investment instruments, which cannot be strictly regarded as the internationalization of RMB.

The key to the problem lies in broadening and deepening the overseas RMB market, expanding channels to access and invest in RMB, establishing a deep pool of RMB overseas and attracting more financial institutions to participate in it, thus realizing the real internationalization of RMB. Broadening and deepening the overseas RMB market will also solve the problem of the imbalance use of RMB in trade settlement. Data from the People's Bank of China show that during the first quarter of 2011 cross-border trade settlements by RMB reached 258.47 billion yuan, in which the actual receipt reached 39.25 billion yuan and the actual payment reached 219.22 billion yuan, with a receipt-to-payment ratio of 1:5. Someone argues that cross-border trade settlements fail to give full play due to the lack of necessary supporting measures but become one of the factors causing the further increase in the foreign exchange reserve. The problem may result from the shortage of the availability of RMB outside Mainland China and channels to hold and increase the amount of RMB. With the expansion of channels for the backflow of RMB and the development of the overseas RMB market, the problem is likely to be solved step by step in the future.

3.4. Accelerate financial marketization reform including interest-rate marketization

On the Third Plenary Session of the Fourteenth Central Committee of the Communist Party of China in 1993, the proposal of interest-rate marketization was put forward clearly in Decisions on Several Issues of Building the Socialist Market Economy System. However, the next 18 years has not seen much progress in the development of interest- rate marketization. Under the current domestic and international situation, accelerating financial marketization reform including interest-rate marketization is conducive to the internationalization of RMB by improving the financial marketable mechanism.

3.4.1. Accelerate the interest-rate marketization reform

Interest-rate marketization means that the interest rates are determined by the demand and supply of capital in the financial market based on the lending rate and rediscount rate of the central bank without any ceiling or floor set by the government. If full convertibility is the marketization of internal and external allocation of RMB as a resource, exchange rate is the important component of the resource's price to determine the allocation between internal and external. Interest rates is obviously the other price to determine the allocation domestically, although interest-rate marketization is not necessary for a "freely usable currency", it affects market mechanism. The huge spread between interest rates and exchange rate of RMB inside and outside Mainland China will lead to the problem of arbitrage or result in a conflict between internal and external balance in monetary policy operations (Wang, 2011). Meanwhile, the full convertibility of RMB is meant to removing the firewall which protects internal financial markets from international shocks. Therefore, It is necessary to speed up the interest-rate marketization reform parallel to exchange regime reform and to promote the development of internal financial market to a wider and deeper one to withstand shock of the international hot money flows and other external turbulence.

There are certainly some risks in interest-rate marketization. First, interest-rate marketization increases the market risk that the internal economic entities have to confront. It poses a big challenge to the domestic financial market participants, especially the commercial banks. Second, interest-rate marketization complicates the financial market, which may increase the risk of financial market turbulence.

3.4.2. Open up the financial market to both domestic and international financial institutions at same time

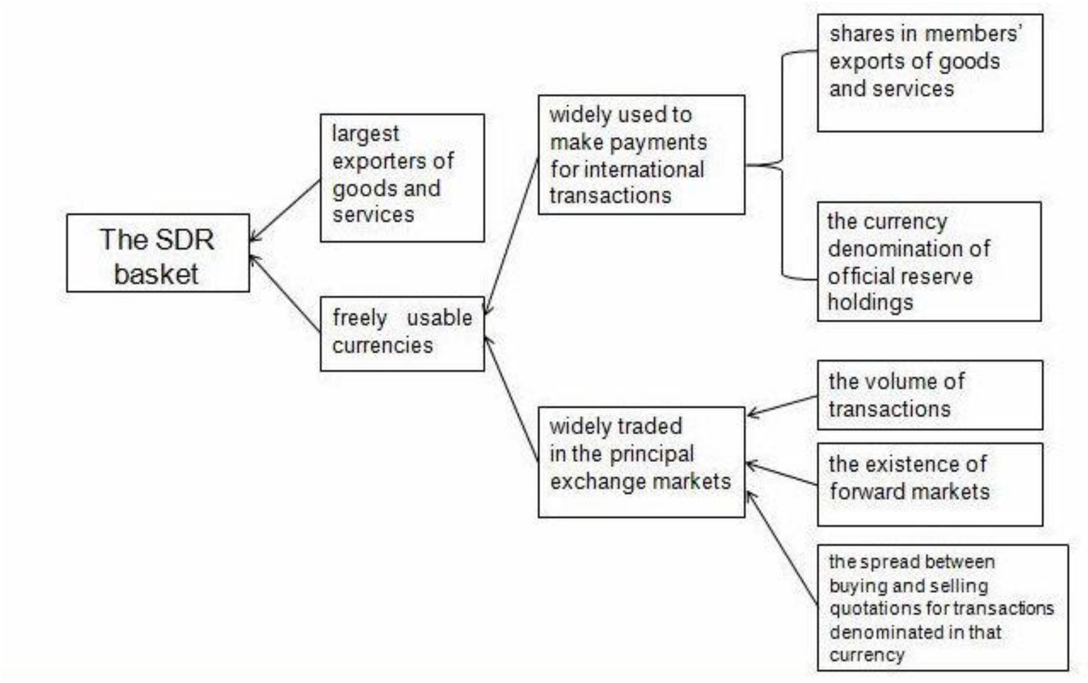
Financial institution marketization is an important manifestation of financial marketization. Considering the current situation of China, we should improve the corporate governance structure of financial institutions, especially the commercial banks, and create a new financial enterprise system. From the internal aspect, we should encourage private enterprises to enter the financial industry and dismantle barriers for non-stated own entities entry into financial industries. From the external aspect, we should further release the control over foreign funds' entry into the financial industry and reasonably increase the equity ratio of foreign capital in financial institutions and promote the financial marketization reform.

In order to make RMB a freely usable or a fully convertible currency, we should solve more problems not only mentioned above. It is understand that not all the problems are provided with solutions yet at present, and different people have different views on the existing solutions. However, the direction to solve these problems is clear i.e. further reform and opening-up, and many problems will be solved on the track towards this direction.

In a word, there exists an opportunity for China to speed up financial marketization reform, and the inclusion of RMB in the SDR basket currency is possible. It is of crucial importance to sufficiently consider the international requirements for including RMB in the SDR basket and the internal economic capability of adapting to the reform and to speed up properly the internationalization of RMB, the exchange rate reform, and interest-rate marketization etc. Meanwhile, we suggest that the IMF carefully study and review RMB whether meets the criteria for its inclusion in the SDR basket and propose the IMF to include RMB and other currencies into the SDR basket currencies in the scheduled 2015 review. Certainly, follow-up work such as the weights and which interest rate representing RMB, as well as how to adjust the weights of other SDR basket currencies etc. could be discussed and studied later.

All in all, the inclusion of qualified emerging economies' currencies, including RMB, in the SDR basket is conducive to creating a sound and healthy IMS. The series of measures being taken or to be taken by China are promoting the internationalization of RMB and making RMB getting closer to a "freely usable currency". We estimate that RMB will be a SDR basket currency when the IMF reviews the SDR valuation method in 2015. It is not an deliberately seeking goal of Chinese government at this stage, but rather a natural result of a series measures taken by China to move forward the financial reform both internally and internationally, However, it is worth to pointing out that when draw up and carry out the measures mentioned above, it is imperative to take into account the timing and possibility of RMB to be accepted into SDR currency basket in 2005. It should also be pointed out that the inclusion of RMB in the SDR basket is the initial stage of the internationalization of RMB and it does not mean that RMB is already a principal international reserve. Great efforts need to be made to make RMB a principal international reserve in the future.

Appendix 1: The Analysis of the Criteria of the SDR Basket Currencies



The figure is made by SDRF in accordance with the criteria for the inclusion of a currency in the SDR basket from *Articles of Agreement of the International Monetary Fund*.

Appendix 2: SDR Valuation Basket: Percentage Weights at Inception of Period (1981-2015)

Year	Currency Code	Currency	Weight
1981-1985	USD	U.S. dollar	42%
	DEM	Deutsche mark	19%
	JPY	Japanese yen	13%
	FRF	French franc	13%
	GBP	Pound sterling	13%
1986-1990	USD	U.S. dollar	42%
	DEM	Deutsche mark	19%
	JPY	Japanese yen	15%
	FRF	French franc	12%
	GBP	Pound sterling	12%
1991-1995	USD	U.S. dollar	40%
	DEM	Deutsche mark	21%
	JPY	Japanese yen	17%
	FRF	French franc	11%
	GBP	Pound sterling	11%
1996-1998	USD	U.S. dollar	39%
	DEM	Deutsche mark	21%
	JPY	Japanese yen	18%
	FRF	French franc	11%
	GBP	Pound sterling	11%
1999-2000	USD	U.S. dollar	39%
	EUR	Euro	32%
	JPY	Japanese yen	18%
	GBP	Pound sterling	11%
2001-2005	USD	U.S. dollar	45%
	EUR	Euro	29%
	JPY	Japanese yen	15%
	GBP	Pound sterling	11%
2006-2010	USD	U.S. dollar	44%
	EUR	Euro	34%
	JPY	Japanese yen	11%
	GBP	Pound sterling	11%
2011-2015	USD	U.S. dollar	41.9%
	EUR	Euro	37.4%
	JPY	Japanese yen	9.4%
	GBP	Pound sterling	11.3%

Source:

International Monetary Fund (2005), Review of the Method of Valuation of the SDR, October 28.

International Monetary Fund (2010), Review of the Method of Valuation of the SDR, October 26.

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