Fiji Sun
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Saturday, Dec 5 2015

Renminbi, now the world's fifth reserve currency

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The International Monetary Fund (IMF) has announced this week that the Chinese currency, the renminbi will be counted as one of the world's select band of currencies: the British pound, the yen, the euro and the US dollar. In 2000, the euro replaced the German mark and the French franc.

The effective date for the renminbi to become reserve asset is October 1, 2016.

By being included in the basket of Special Drawing Rights (SDR), the renminbi becomes the fifth reserve currency to help set the value SRD, as an international reserve asset. SRD was created by IMF in 1969 to supplement its 188 member countries' official reserves. The proportion of currencies in the basket is: British pound: 11%; Japanese yen: 9%; the euro: 37%; and the US$: 42%. From October 2016, the proportion will be: the pound: 8%; yen: 8%; renminbi:11%; the euro: 31% and the US$: 42%.

The value of SDR will be determined by these five currencies.

SDR

Long ago, countries in the trading world after running out of foreign exchange reserves, used to settle their external payments in terms of gold. As the supply of these two key reserve assets (gold and the US dollar) became inadequate for supporting the expansion of world trade and financial flows, IMF created SDR as a new international reserve asset.

Instead of adding to reserves of any given country through incurring external debt, SDR is now used to supplement its member countries' reserves. SDRs are allocated to IMF members from time to time. SDR is not a currency. It is a potential claim on the freely usable currencies of IMF members, which holders of SDRs can obtain in exchange for their SDRs. The IMF can arrange members with strong external positions, to purchase SDRs from members with weak external positions.

The total SDRs available to member countries are about SDR 204 billion, one SDR being equal to US$1.37. Fiji's SDR holding is SDR 51 million and allocation is SDR 67 million. Once allocated, members can hold their SDRs as part of their international reserves or sell part or all of their SDR allocations. They can exchange SDRs for any of the four currencies in the current

SDR basket among themselves. IMF pays interest to each holder of SDRs; it charges the same rate on each participant's net cumulative SDR allocations (i.e. the SDRs that were allocated to a member by the Fund in the past, net of any cancellations, which in practice have not taken place to date). Thus, in net terms, members receive interest at the SDR interest rate on the amount that their holdings exceed their cumulative allocations. Conversely, if a member's SDR holdings are below its allocation, it incurs a net interest obligation.

Freely usable currencies

The term freely usable does not mean freely floating. It refers only to its actual international use. The renminbi eminently fulfills one part of the criterion: use in trade. The world's second largest economy, China's GDP is US$ 10.4 trillion (17% of world's GDP), while its trade is US$ 4.3 trillion, accounting for 23% of world trade.

The other part of the criterion, the volume of currency trading in renminbi is less than 2% of world GDP.

Many countries have trade deficits with China, with the exception of mineral exporting countries in Africa. There were always suspicions that China had been manipulating its currency for promoting its exports. The fortunate African countries with trade surpluses are keen that China does not spring yet another surprise on the world with one more "beggar thy remedy" - devaluation- for coming out of the economic downturn!

Their renminbi holdings will then dwindle in value.

Reforms for confidence

Rise in volume of currency trading can be promoted only through confidence. Interaction of free market forces, which are generally predictable, being based on fundamentals of the economy and transparency, would raise confidence in use of currency. The time tested four currencies of the world, the pound, yen, euro and US dollar have proved the criterion. The managed currency does not inspire confidence.

IMF has given notice of ten months for reforms. China has already allowed foreign investors to access its stock markets. Establishment of Offshore RMB Trade in London is another positive step. The rate determined here, "away from home", will be the benchmark for SRD.

The latest decision by IMF is a political victory for China. As a communist country with one party government, China has done it. The renminbi is now put on the same pedestal along with super four currencies of the capitalist world.

Whether the other Chinese ambition, namely ending the hegemony of the US dollar would be fulfilled, remains a question.