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Global Reserve Currencies and the SDR

- The issue of the 'international reserve currency' and the possible role of the IMF's Special Drawing Rights (SDR) has moved from obscurity to the centre of discussions about the future.
- Given China's importance in terms of its share of world trade, the CNY should now be part of the SDR. The case for including it can only become more obvious as this decade progresses.
- However, actually including the CNY as a constituent of the SDR is likely to remain a challenge without the CNY becoming more widely used internationally, including as a reserve asset.
- The case for including other BRIC currencies in the SDR, especially the RUB, is also likely to become stronger over the coming decade.
- Although the Dollar will probably not be as dominant in 2020 as it is today, it is far from clear that it needs to be replaced by the SDR—or by anything else—as the main reserve currency.
- For the SDR to be attractive to private users, it will need to include the CNY and possibly other BRIC currencies. However, this alone would not guarantee that the SDR would be more attractive to private investors.

Thanks to Enoch Fung,
Shirla Sum and Swarnali Ahmed

Michael Buchanan and Jim O'Neill

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Summary

- **Although historically the global financial system has usually been dominated by a single reserve currency, the dominance of the USD has become of greater concern in recent years, especially in the wake of a global financial crisis that had its epicentre in the US economy.**
- **The issue of the 'international reserve currency' and the possible role of the IMF's Special Drawing Rights (SDR) has thus moved from obscurity to centre stage. The amount of SDR assets and liabilities is rising after the April 2009 G20 meeting agreed to triple the IMF's lending resources.**
- **We outline how the SDR operates within the system today; look out to 2020 to see how it could be made to deliver a better overall reserve asset mix; and assess how changes in the global economy over the next decade are likely to affect the need for reform of the SDR.**
- **The SDR will need to see a change not just in its weights but also in its components to be economically representative. In terms of economic importance (size and share of world exports), the CNY must surely become an important constituent of the SDR, although currently this is less true when looking at the use of the CNY as a true reserve asset.**
- **The case for other BRIC currencies, especially the RUB, to be included in the SDR is likely to grow this decade.**
- **An increased role for the SDR could help reduce FX risk for asset and liability holders (at least from today's starting point of heavy reliance on the Dollar). SDR issuance could also help reduce the need for countries that want more reserves to obtain them by deliberately running large current account surpluses. Providing the reserves up front through SDR issuance would thus aid in global rebalancing. Providing more SDR assets would spread out the gains from seigniorage more broadly, and also reduce the structural risks associated with requiring the US to pump out more USD assets for the still-growing stock of overall reserves.**
- **Overall, we think it is most unlikely that any increased role for the SDR would significantly alter the overall role of the USD as the reserve asset of choice—the incumbency advantages of the USD are likely to dominate for the foreseeable future, despite the rise of the BRIC countries.**
- **Although the Dollar is unlikely to be as dominant in 2020 as it is today, it is far from clear that it needs to be replaced as the main reserve currency.**

Global Reserve Currencies and the SDR

The issue of the 'international reserve currency' and the possible role of the IMF's Special Drawing Rights (SDR) has moved from obscurity to centre stage. Since floating exchange rates began in the 1970s, the global financial system has been dominated by the Dollar. This dominance has become of greater concern in recent years, especially in the wake of the global financial crisis. As a result, the desire to explore alternatives has grown. This paper looks at why interest in the SDR has increased. We outline how the SDR operates within the system today; how changes in the global economy over the next decade are likely to affect the need for a reform of the SDR; how China may play a large part in determining the nature of the reserve currency system, and whether the private sector has any real need for such an SDR.

1. The Issue of the SDR and the Dollar

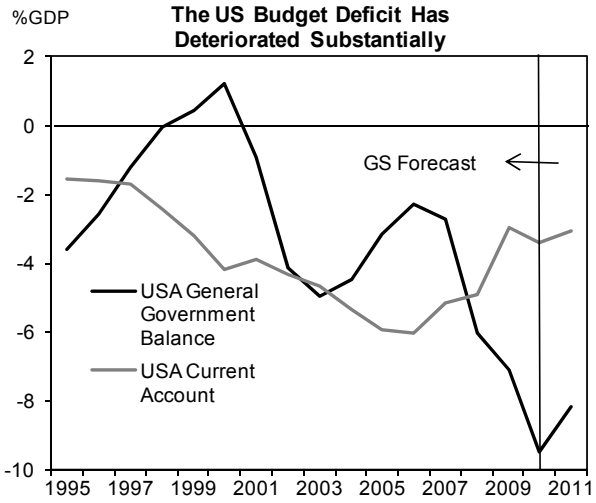
The global financial system was dominated by the USD for most of the last century, including in the period of floating exchange rates. Previous to the 20th century, the Pound played a similar role. If this century is all about China, then will it ultimately be dominated by the CNY? Or is there a need for a multiple currency reserve system, especially in the interim?

Global financial system was dominated by the USD for most of the last century

Why the Concern About the Dollar?

The debates about Dollar dependency are not new. Indeed, they have been with us for many of the past decades, including during the first decade of the Euro's existence, when many believed that an alternative might be appearing at last. However, the heightened focus on the topic really emerged recently, following the web-based article published by Governor Zhou of the People's Bank of China (PBoC) just before the April 2009 G20 meeting[1]. In it, Governor Zhou articulated the case for the development of the SDR. While there has been much discussion about the Governor's motives—and many remain unsure about precisely what they are—the issue reminded us all of the dilemma of the world's dependency on the Dollar, and all the associated issues. Whether the PBoC wants to have an SDR with a different method of calculation (see the Appendix 1 on page 15 for the current determination), and whether this would include some role for the CNY, is unclear. We explore some of these issues in Section 2.

If this century is all about China, will it be dominated by the CNY?



Source: GS Global ECS Research

1. Zhou Xiaochuan, People's Bank of China (PBOC), *'Reform the International Monetary System'* published in http://www.pbc.gov.cn/english/detail.asp?col=6500&id=178

The dependency on the Dollar, even before the 2007-2008 credit crisis, and the accumulating external imbalances of the US are well-known reasons for many long-term fears about the Dollar's value[2]. And, since the aggressive US policy response in late 2008, the dramatic increase in the US federal deficit has escalated these fears to a new level among many. The fact that the external deficit has fallen to around 3% of GDP and that the Dollar has performed reasonably well throughout much of the 2008-to-date environment does partly reduce some concerns. In addition, the structural issues that have risen more recently with the Euro-zone periphery may serve to reduce the attractiveness of the EUR as an alternative reserve asset, at least for a time. Overall, there are still significant issues at the core of the debate about the role of the Dollar and the potential for the SDR.

The high overall level of global reserves today increases the systemic risk associated with holding the majority of reserve assets in one currency

FX Reserves Too Large?

The very high overall level of global reserves today increases the systemic risk associated with holding the majority of reserve assets in one currency. Reserves held by foreign central banks have grown from 34% of total USD government debt in 2000 to 68% today, meaning a switch by reserve managers could have a greater impact than before (and any losses of reserve managers are higher in relation to GDP). However, the magnitude (and perhaps even the sign) of this effect is unclear. It really only matters if reserve managers behave differently to private investors. It seems at least plausible that some large reserve managers are more likely to be biased towards USD holdings and could, in the future, adjust holdings in a lumpier (or at least more uni-directional) way than private investors. In addition, any clear decision on allocations by reserve managers may have a greater impact on market sentiment than a similar-sized shift from any individual private agent.

The share of reserve currencies held in USD has fallen since 2000 (from 71% in 2000 to 62% in 2009). While this data does not include all countries, it is broadly representative of the overall holdings of reserve assets. As mentioned earlier, despite concerns that the USD's role would quickly fade as it was the epicentre of the global credit crisis, the USD actually confirmed its role as a safe haven. In that sense, the crisis has served the USD (unlike the US economy) well. Countries need access to reserves in times of trouble, so it is critical that the currency maintains its value in such times, and that its markets remain sufficiently liquid to allow the reserves to be tapped easily. The USD has proven its worth on those grounds during the crisis, perhaps also aided by the bid for the currency as foreign banks scrambled for USD liquidity in the

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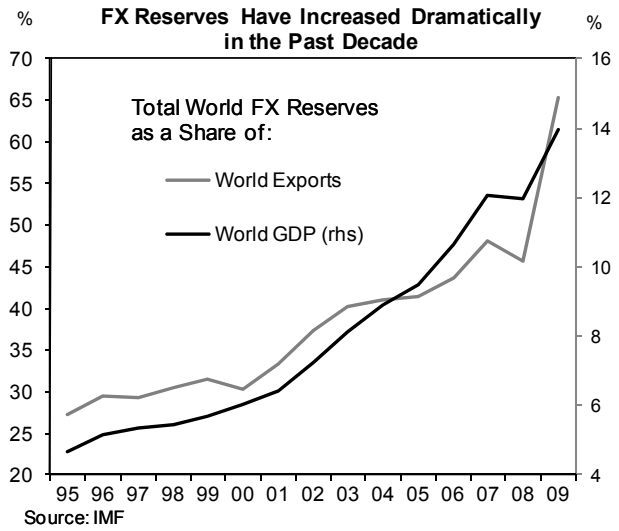
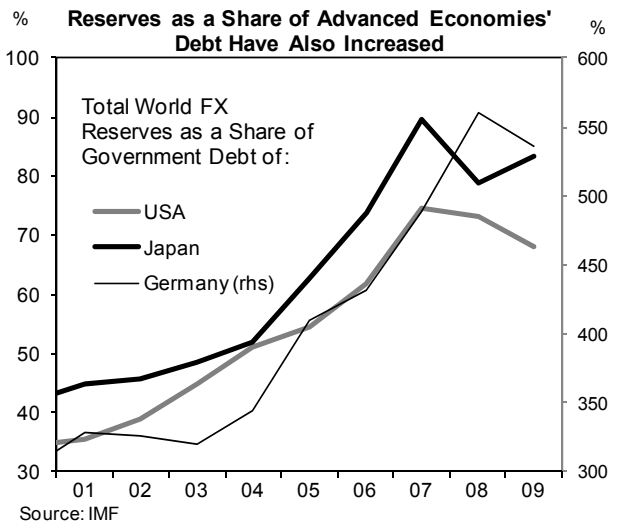
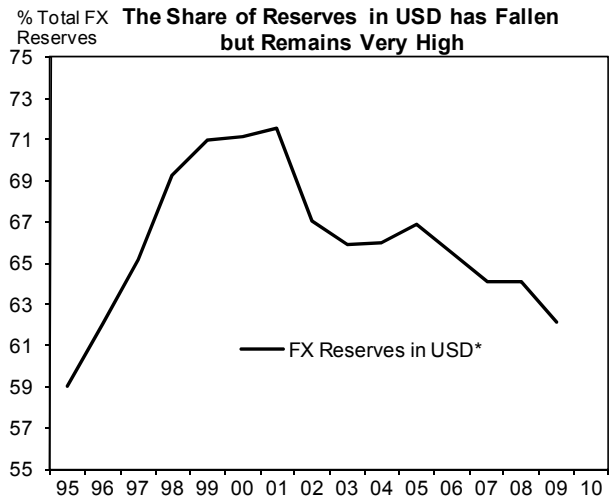




2. See Jim O'Neill, "The Outlook for the Dollar in the Next Decade", *Global Economics Paper* 180, February 17, 2009.



*excludes China. Source: COFER (IMF).

early stages of the crisis. Nonetheless, the fragilities in the US economy highlighted by the crisis have created significant interest in diversification of reserve assets further into the future.

The fragilities in the US economy highlighted by the crisis have created significant interest in diversification of reserve assets further into the future

A build-up of very high levels of precautionary reserves after the Asia Crisis led many emerging markets to prefer 'self-insurance' in the form of holding a 'war-chest' of reserves rather than relying on heavily-conditional lending from the IMF. Moreover, there was a build-up of reserves well beyond normal precautionary levels in China—other countries have done this at times too, but not when they were as large in absolute terms as China is, and so it had less of an impact on the global financial system.

In addition, with some key central banks holding levels of reserves well in excess of what is likely to be needed to support their currencies in times of distress, there is a greater focus on appropriate portfolio diversification (i.e., the concern is not just about liquidity in times of need, but also about returns). One way to achieve that is to enhance or create alternative reserve assets, such as the SDR (as we discuss below). In some senses, this is more of a 'Sovereign Wealth Fund' issue than a pure reserve currency issue. Effectively, there are two separate issues: which currencies should be the true reserve assets in which central banks hold their foreign assets for emergency use, and in which much of global trade and FX transactions would be denominated; and which currencies do SWFs choose to hold their additional foreign assets.

As key emerging markets grow in importance in the global economy, they may be less inclined to allow the US to earn the free 'seigniorage' money that comes with its role as issuer of the reserve currency. Some of today's largest holders of reserve assets are large, fast-growing emerging markets. These countries did not sign up to, nor do they benefit from, the post-World War II exchange rate regime in the same way as, say, Western Europe. As a result, they may be less inclined to accept a status quo in which the US gets to give claims on its economy, in exchange for goods and services, to foreign reserve managers who tuck them away indefinitely, thus providing a form of seigniorage to the US. For these reasons, it is perhaps unsurprising that it was a policymaker from one of these fast-growing emerging markets who was most vocal in raising the issue of a new international reserve asset. As we mentioned above, PBoC Governor Zhou pushed the idea of a new 'super-sovereign reserve currency' in early 2009. Depending on how such a reserve asset were created, this could help share out the benefits of reserve-asset seigniorage more widely. For example, if it were done through the creation of more SDR assets, the benefits of being a reserve-asset-creator would effectively be distributed to the IMF membership in proportion to quotas (yet another reason why it remains

As key emerging markets grow in importance in the global economy, they may be less inclined to allow the US to earn the free 'seigniorage' money that comes with its role as issuer of the reserve currency

important to get the IMF's voting shares right). We explore the role of the SDR in the context of a global reserve system below.

These issues are interlinked. Having reserve currency status allows the US to borrow from abroad at a lower cost than would otherwise be the case (the seigniorage effect noted above—the US is able to buy foreign goods or assets in exchange for a USD that is not redeemed), and so perhaps has contributed to the fragilities (over-indebtedness) that now worry some of the reserve holders. Relying more on the SDR to provide global reserve assets would spread the benefits (seigniorage) and costs (potential instability in holding of assets issued) around all the members of the IMF in proportion to their voting rights (quotas). Moving to a multi-polar reserve currency world (i.e., including a bigger role for say the EUR, GBP and JPY and eventually the CNY) would also spread around the costs and benefits, albeit in a more piecemeal way.

Relying more on the SDR to provide global reserve assets would spread the benefits and costs around all the members of the IMF in proportion to their voting rights (quotas)

With this general background in mind, we focus here on the current and future role of the SDR. We look at its potential usage as the reserve currency of the future, as part of how the world will likely evolve by the end of 2020.

2. Rebalancing the SDR—Making it More Representative

Time to Rebalance Again

Under current rules, the SDR is due to have its components reviewed three times by the end of the 2020: first, towards the end of 2010, next in 2015 and then by the end of 2020—and our forecasts imply a substantial reweighting is justified.

The choice of currencies to form the SDR is set as the four currencies issued by IMF members that have the largest exports of goods and services (estimated over a five-year window). Once a currency is in the SDR basket, its weight is then determined by two factors: the value of exports and the amount of reserves other IMF members hold in that currency. On that basis, since the start of 2006, the weights based on their roles in international trade and finance are: USD (44%), EUR (34%), JPY (11%) and GBP (11%). There is no particular economic reason to limit the list of currencies to four. However, the IMF's current Articles of Agreement require that any currency in the SDR be "freely usable".

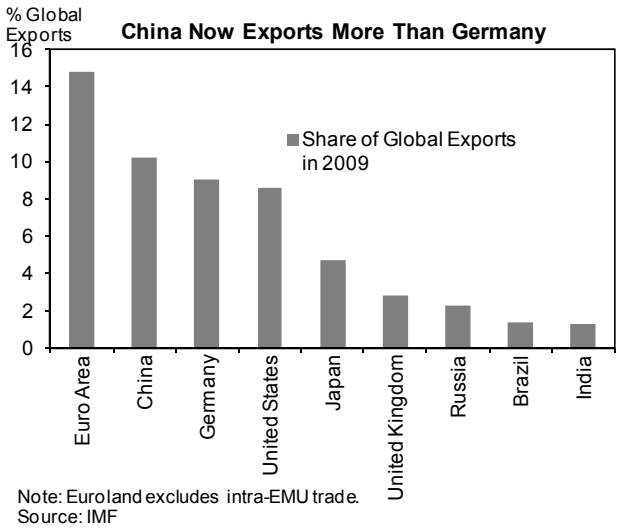
Under current rules, the SDR is due to have its components reviewed three times by the end of the 2020

The table below shows the latest estimated size of the US, the Euro area, Japan and the UK; their percentage share of the world economy; their share of world exports and services, and their share of the SDR. The table also shows the size of Germany—the Euro area's largest single economy—simply for comparison purposes, and that of each of the four BRIC economies, as well as their shares of world exports and world GDP.

Table 1: Size of Economies and Exports, Today and 2020

	GDP	Share of Global GDP	Share of Global GDP	Share of Global Exports*	Share of SDR	GDP	Share of Global GDP	Share of Global GDP	Share of Global Exports**	Share of Global Exports***
	US$bn	%	PPP	%	%	2007 US$bn	2007 US$	PPP	real $ growth	BRICs 1/2 growth
	2009	2009	2009	2009	23-Mar-10	2020	2020	2020	2020	2020
United States	14256	25	20	9	44	18390	21	18	7	8
Euro Area	12517	22	15	15	34	15037	17	12	11	13
Japan	5068	9	6	5	11	5024	6	5	3	4
United Kingdom	2184	4	3	3	11	3596	4	3	2	3
Germany	3353	6	4	9	na	3989	5	3	7	8
China	4909	9	12	10	na	13167	15	19	21	13
India	1236	2	5	1	na	3166	4	7	2	1
Russia	1229	2	3	2	na	2995	3	4	3	2
Brazil	1574	3	3	1	na	2664	3	3	2	1

*Euro Area exports excludes intra-EMU trade. **Assume exports grow at the same rate as GDP growth. ***Assume exports grow at the same rate as GDP growth for all except BRICs. In BRICs, exports grow at half of past decade's (average) GDP growth. Source: IMF, GS Global ECS Research

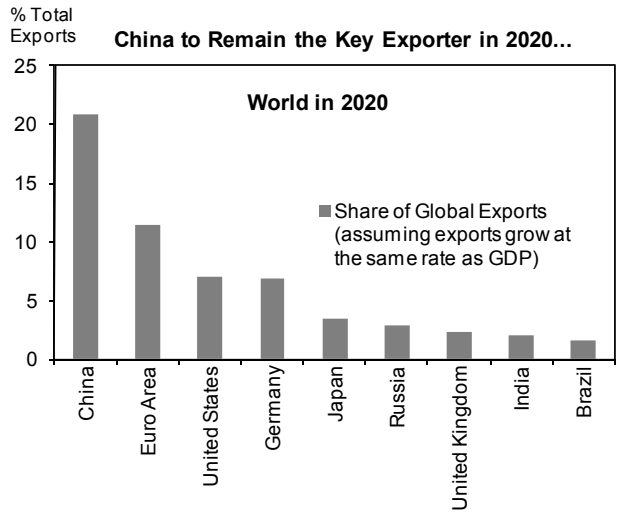


Note: Euroland excludes intra-EMU trade.
Source: IMF

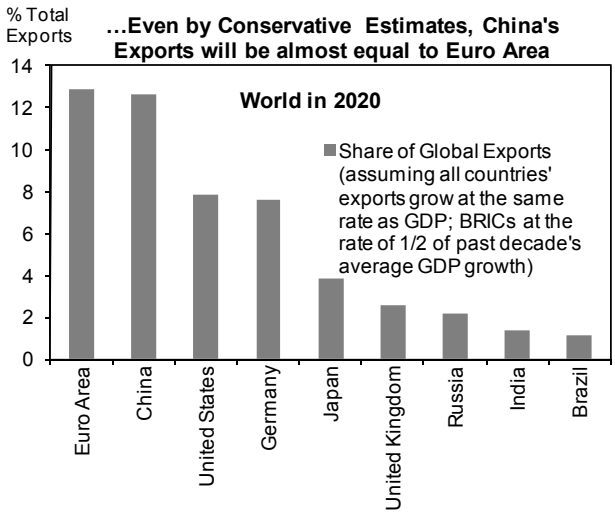
While the US accounts for a large share of global GDP, its share of global exports—a key criterion for inclusion in the SDR—is now similar to that of China. China's share of exports, along with the sheer size of its GDP, actually raises the question of whether future SDR revisions should consider including the CNY. Of course, as the CNY is not "freely usable" at the moment, IMF Articles prevent its inclusion.

China's share of exports, along with the sheer size of its GDP, raises the question of whether future SDR revisions should consider including the CNY

Looking out to 2020, if our forecasts were to materialise, the combined GDP of the four BRIC economies (Brazil, Russia, India and China) may have surpassed the United States at market exchange rates. China on its own will have become around two-thirds the size of the US. Brazil, Russia and India will have exceeded the size of the UK, and will be heading towards becoming as big as Japan. We made some simple projections using our existing BRIC forecasts for GDP, and assuming that the BRICs' share of trade rises only in line with GDP (a huge slowdown on the recent past), and that the SDR weights were based only on the value of exports, then in 2020 the SDR would comprise: CNY (46%), USD (16%), EUR (25%), JPY (8%), GBP (5%). If we base the weights in the SDR using the value of exports in 2009, the SDR would already comprise: CNY (25%), USD (21%), EUR (36%), JPY (11%), GBP (7%). Even if we assume that the CNY only ends up accounting for the same amount of reserve assets in 2020 as the JPY does today, then a simple average of the exports and reserves criteria would suggest a weight in the SDR of around 24.5%.



Euro Area excludes intra-EMU trade. Source: Global ECS Research



Euro Area excludes intra-EMU trade. Source: Global ECS Research

Source: IMF

The other key criterion in determining the SDR weights currently is the importance of each currency in the total reserve assets of other IMF members. A currency's role as a reserve asset does not necessarily automatically follow its weight in global trade—there are strong incumbent advantages, and so even the CNY will face a tough time gaining share. The currencies of the other much smaller BRIC countries are unlikely to make much headway as true reserve currencies (as opposed to being part of SWF portfolios).

It also makes the process a bit circular—China may want to move the world away from a USD-dominated reserve currency system and towards the SDR in order to reduce the seigniorage that flows to the US, but the weight of its own currency will initially be limited by its low share in global reserves. In other words, until it gets a greater weight in global reserves in its own right, it doesn't gain as much from an increasing role for the SDR.

It is hard to imagine that the CNY will be used in a widespread way in the foreseeable future, and, in that sense, its usefulness as a reserve currency will still be limited

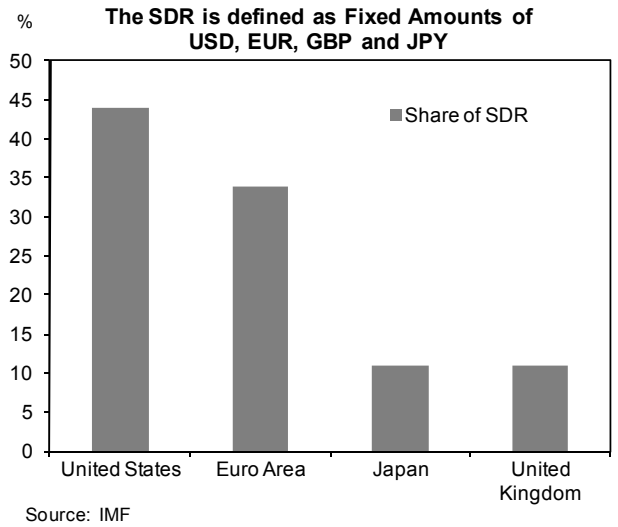
China has signalled that a shift is coming in the usage of the CNY. The degree of change and the speed at which this change will occur remains unclear but, as with other issues, it will probably be gradualist. It is hard to imagine that the CNY will be used in a widespread way in the foreseeable future, and in that sense, its usefulness as a reserve currency will still be limited.

3. The SDR—Partly a Currency, But Hardly Your Average Variety

The SDR is a curious construct. It is not a currency in the same way as most single-country currencies, but it is used as a medium of exchange among a limited range of counterparties, and (unlike some historical basket currencies) does allow some degree of flexibility over issuance:

- **The SDR is not a 'normal' currency:** It is not issued by a specific single government; it is not backed by the tax revenues of a particular country or group of countries; nor is it backed by a particular claim on a tangible asset (e.g., there is no link to gold). Unlike even the EUR, the SDR does not have independent monetary (interest rate) policy—the SDR interest rate is just the weighted average interest rate of the component currencies[3]. However, although it is defined as fixed amounts of USD, EUR, GBP and JPY (see Appendix 1 for a detailed explanation of the SDR rules), it is far more than just a simple weighted average of other currencies.

3. The SDR is not the same as the ECU (the precursor to the EUR). When the ECU was in existence, it was not used in the same was as the SDR within the confines of the IMF, and ECUs were not created to expand reserve assets (as has been done with the SDR). The SDR is also different from the EUR. True, the EUR is backed by the fiscal resources of many separate states. The IMF does not set the SDR interest rate, for example. Rather, the SDR rate fluctuates as a weighted average of the rates on each of the constituent currencies – whereas the ECB runs policy for the Euro area.



- **The SDR is used to exchange claims but only by central banks.** In an important sense, anything that people are willing to use as a medium of exchange is a type of currency. As an extreme example, one of Australia's most effective early domestic currencies after British settlement was rum. Rum took the place of the official currency as there weren't sufficient Sterling coins available. As long as people are willing to exchange goods between each other in exchange for a particular item, be it rum, gold or the USD, then, in some senses, that item is a currency. So, is the SDR a currency in that 'medium of exchange' sense? Yes, but only for some institutions. Within the confines of the IMF, central banks have agreed voluntarily to exchange SDRs (which have been created by IMF Board agreement and provided to each country) for hard currency (e.g., USD). Under IMF agreements, some member central banks agree to exchange SDRs for USD as required by the rest of the membership. This means that a country that has been allocated an SDR asset by the IMF can use that 'money' to buy USD and then use the USD (or other externally accepted currency) to buy goods and services outside the IMF (including for FX intervention).

A greater reliance on SDR reserve issuance could potentially contribute to global rebalancing, and would be less deflationary

- **The SDR could become more important in response to the rise in the level of official FX reserves described above, even if it remains the exclusive domain of central banks.** If reserves are accumulated because they are valued in their own right (to provide currency stability and other precautionary reasons), then the creation of more SDR assets by the official community as a policy choice in response to investor (including SWF) demand could provide advantages for the global economy and individual member states. Further issuance of SDR assets would mean that countries could increase FX reserves without having to run BoP surpluses for years. In that way, using SDRs would held reduce the need for the 'perverse' capital flow situation where lower-income emerging markets save up and send the capital to one of the world's richest economies. A greater reliance on SDR reserve issuance could also perhaps contribute to global rebalancing and would be less deflationary. Emerging markets would get their reserves 'for free' from the IMF in SDR terms, and so would not have to run current account surpluses to build up their war-chests. This would allow domestic demand in those countries to run stronger than otherwise would be the case, and so help provide external demand to the US. This would help reduce global trade and savings imbalances, and reduce the chance of deflation (as the world moves more clearly out of recession, it is perhaps the global imbalance issue that will be more critical in the near term than avoiding deflation). It would also help spread the benefits of providing the reserve currency across the full IMF membership rather than just to the US. Returning to the analogy of Australia's colonial history, control over rum

Emerging markets would get their reserves 'for free' from the IMF in SDR terms, and so would not have to run current account surpluses to build up 'war-chests' of reserves

created substantial seigniorage for those naval officers who controlled the supply, and created much political tension with those who did not. To perhaps stretch the point a little, it also led to the 'Rum Rebellion' in 1808, the only armed takeover of government in Australia's history. Increasing the share of reserve assets that provide seigniorage to all IMF members could reduce that political flashpoint.

- **Would *countries* want to hold more SDR assets and liabilities?** If additional SDR assets are to function as true reserve assets (as opposed to 'excess' reserves or Sovereign Wealth Funds), they need to be usable in a crisis situation—the ability to convert quickly and easily from SDRs into USD would thus continue to be a critical feature. This is possible now within the IMF. But what would happen if far more SDRs were created? After the agreement at the April 2009 G20 meeting to triple the IMF resources up to $750bn (from $250bn), member countries have remained willing to fully exchange SDRs for USD as requested by other member countries (countries need the USD to engage in transactions outside the IMF, as the SDR can only be used with the IMF under current arrangements).

- **The increase in possible SDR issuance from the IMF is a contingent asset and liability—it is only created if a member country borrows from the IMF.** The G20 agreement described above is only a *potential* tripling in IMF resources. However, with a number of new high-access credit facilities having been recently created by the IMF, and with possible demand from developed economies (including Euro-zone members) as well as emerging markets, it seems plausible that the share of global assets and liabilities denominated in SDR terms will rise. The IMF membership has effectively agreed to accept the consequent SDR/USD flows that would result if these programs are triggered, for now. It could eventually be the case that some central banks find that their reserve holdings were overly weighted towards the SDR (i.e., away from purely the USD towards the other constituent parts to an extent that exceeds the structure of their liabilities)[4]. However, as some key countries have sought to get more SDR assets (including the earlier IMF program of SDR note issuance to China and others) as a way to diversify reserve holdings, there is probably still significant room for a rise in the ratio of SDR reserves to total reserves before any such concerns become a constraint.

The SDR is used increasingly at a central bank level, but what is to stop the private sector using the SDR too?

4. SDR for the Private Sector?

The private sector could seek to use the SDR in two main ways: it could just start using the SDR as a way to express a basket-currency approach (easy but with only modest advantages), or it could gain access to the IMF as a source of true SDR assets and liabilities (far less likely but far more impactful).

If the private sector 'goes it alone':

- **It can use the SDR as a unit of account—**the private sector could choose to hold its assets in any mix of currencies if it so chooses. The current weights of the SDR component currencies are published, and the SDR rate against the USD is posted on the IMF website every day. So if the private sector wanted to express an asset in SDR terms, it could do so now. However, it does not currently have access to central banks willing to provide USD (or other externally-usable currencies) in exchange for SDR units. A private-sector issuer of the SDR asset would thus need to use the funds from selling the asset to buy exposure to each of the underlying component currencies.

4. When a country has most of its reserves or liabilities in USD, it may make sense to increase the proportion denominated in SDRs. But just because the SDR is more 'stable' in terms of its value against other currencies and assets (because it is a weighted average of major currencies, not just one major currency) does not mean that it is better to have all assets and liabilities in that form. Volatility could be a good thing if it moves in the right direction—in other words if a country had all your liabilities in USD, then it wouldn't want *all* its assets in SDRs as a sharp move of the USD against the other constituents of the SDR would worsen its net foreign asset position.

The buyer of the SDR asset would need to rely on the issuer to make good the payment in either a mix of currencies (or in one particular currency but at the relevant exchange rate against the SDR on the day of expiry of the claim). The SDR would simply be a unit of account, and as there is no true 'SDR' unit for the private sector to hand over, it would be a synthetic product—albeit one that was defined by a third party (the IMF).

- **However, over time, there is a 'basket composition' risk in using the SDR per se** (as opposed to using a one-off basket with the same weights as *today's* SDR). The IMF can rebalance the components of the SDR, and normally does so every five years (as we discuss in detail below). In addition, the list of component currencies could change (i.e., the IMF can change not just the weights of the existing component currencies, but also which currencies are included). While the private sector can easily hedge the currency movements of the components of a fixed basket (with the caveat below on a possible CNY inclusion), it would be extremely difficult to hedge appropriately the risk of a basket reweighting. Some attempt could be made to estimate the change in trade shares and reserves that are used in part to determine SDR weightings. But not only is that very difficult and imprecise, there is also an intensely political overlay on that process, especially in relation to the CNY. As a result, it would be very hard for the private sector alone to provide a long-term true SDR instrument. It might be possible to formulate an instrument that automatically rebalances in line with the IMF's SDR weights, but then this would require special attention to the possible inclusion of nonconvertible currencies such as the CNY, as discussed below.

It would be very hard for the private sector alone to provide a long-term true SDR instrument

- **In addition, the private sector may face additional costs if the CNY were to be included in the SDR before it is fully convertible (and the private sector cannot gain access to an IMF SDR window, as discussed below)**. Within the confines of the IMF, the CNY could operationally be included in the SDR even while China maintained some capital controls (although it is currently against the IMF's Articles of Agreement, and there would be some political issues to resolve). China could agree to make any payments required *within the IMF* without restriction. But for the *private sector*, there would not be full access to holding onshore CNY assets as a hedge for an SDR-denominated claim. That would mean that the private sector might be forced to use NDFs to gain exposure to the CNY part of the SDR (i.e., sellers of an SDR asset would need to hedge their implicit CNY liability by buying CNY NDFs). This would typically be more expensive than getting onshore exposure.

Alternatively, the private sector could eventually get support from the official community:

- **If the private sector were given full access to an 'IMF SDR window', then there would be a huge difference in the attractiveness of an SDR that included a not-fully-convertible CNY.** It would allow private-sector corporates and investors to hold the CNY via its weight in the SDR, and so effectively by-pass the capital restrictions.

- **However, for exactly that reason, it seems unlikely that we would see a combination of (i) inclusion of a non-convertible CNY in the SDR, and (ii) the IMF allowing the private sector full access to its SDR window.** In other words, it seems unlikely that China and the official community would allow the private sector to hold an SDR asset and obtain repayment in the current market value of any currency against that claim, if the SDR included a non-convertible CNY. Investors who wanted exposure to onshore CNY could then buy SDR assets and short the other component currencies to obtain 'pure onshore CNY' exposure. While China is keen to increase the

It seems unlikely that China and the official community would allow the private sector to hold an SDR asset and obtain repayment in the current market value of any currency against that claim, if the SDR included a non-convertible CNY

internationalisation of the CNY, it would probably prefer to retain more control over the process via the specific development of an offshore CNY market in Hong Kong (see Appendix 2).

Outlook for private SDR market thus remains challenging

Unless the private sector can make a claim on the IMF or its members in SDR terms, or obtain greater reassurance about the rebalancing of the SDR, these issues will make it difficult for a large SDR private asset market to develop. However, if a broad consensus can be reached among policymakers, the IMF could accelerate the process either by issuing tradable paper directly, or agreeing to a swap with another institution (perhaps another IFI with funding needs, such as the ADB) so that an IFI that normally issues in the market (unlike the IMF) could issue in 'true SDRs' that can be exchanged for USD (or other constituent currencies) with the IMF.

5. The Internationalisation of the CNY—A Precursor to Convertibility and Inclusion in the SDR?

China seems intent on making the CNY more flexible and on reducing capital controls

China seems intent on making the CNY more flexible and reducing capital controls. If this were to develop in a significant way, then the CNY would almost definitely become part of the SDR in the coming decade. There are two issues currently in the spotlight: One is the value of the CNY against the Dollar and other currencies. The other is the degree to which the CNY can be used, especially outside China.

We believe the pilot project for some mainland Chinese exporters to denominate their exports in CNY (rather than the more normal USD) is part of this process. By taking the exchange rate risk off the exporters, it reduces the problems from exchange rate volatility and allows the currency to serve a more useful function. Appendix 2 discusses the pilot projects in more detail.

We believe the pilot project for some mainland Chinese exporters to denominate their exports in CNY (rather than the more normal USD) is part of this process

China has not benefited to the same degree from currency adjustment due to its more rigid exchange rate regime. However, a more flexible regime would only help if the CNY then moved in the 'right' way. In other words, when the Chinese economy slows, China needs the CNY to depreciate (as happened for the UK and Australia). It would be unhelpful if China's huge reserves ended up giving it more of a 'safe haven' status in times of global weakness or uncertainty. In that environment, a more market-driven CNY could conceivably appreciate and so tighten financial conditions in an unhelpful way. However, we do not expect China to move to such a market-driven exchange rate in the foreseeable future, but rather just a more flexible but controlled regime. Nonetheless, that could still make it more likely that the CNY will be included in the SDR.

6. The USD to Remain the Dominant Reserve Asset

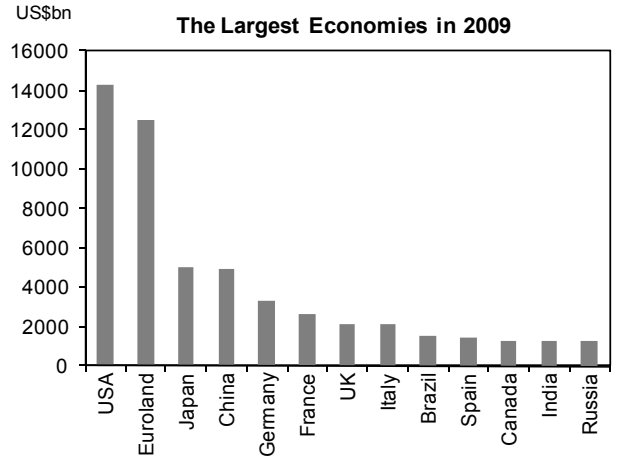
Although the Dollar is unlikely to be as dominant in 2020 as it is today, it is far from clear that the Dollar needs to be replaced as the main reserve currency. The key issue raised by our glance into 2020 is that the SDR will need to see a change not just in its weights but also in its components to be economically representative. As can be seen, in terms of economic importance (both on size and share of world exports, although less so as a party to FX transactions and as a true reserve asset), China and the CNY must surely become an important constituent of the SDR. As discussed earlier, it probably should—based on its economic weight—be a component today. From the perspective of their overall economic size and trade flows, each of the other three BRIC currencies could be part of the SDR by 2020. However, as few countries are likely to use these currencies significantly as true reserve assets, their chances of making it into the SDR are less than the CNY. In the meantime, an increased role for the SDR could help reduce FX risk for asset and liability holders (at least from today's starting point of heavy reliance on the USD). SDR issuance could also help reduce the likelihood of some economies continuing to run large current account surpluses to accumulate reserve assets, and so aid in global rebalancing. Providing more SDR assets for large reserve managers to hold would spread out the gains from seigniorage more broadly, and also reduce the costs associated with requiring the US to pump out more USD assets for the still-growing stock of overall reserves.

The SDR will need to see a change not just in its weights but also in its components to be economically representative

An increased role for the SDR could help reduce FX risk for asset and liability holders

A move to a more multi-polar reserve world could reduce long-term structural risks in the global economy by providing a competitive reason to deliver sound macro policies—the existence of other seriously credible reserve assets would help motivate an adjustment to maintain the advantages of reserve currency status (seigniorage). However, the adjustment process could increase currency volatility, as reserve asset holders switched into alternatives (and the market tried to move pre-emptively). Overall, we think it is most unlikely that any increased role for the SDR would significantly alter the broader dominance of the USD as the reserve asset of choice—the incumbency advantages of the USD are likely to dominate for the foreseeable future. This need not be cause for concern in the rest of the world, as long as the US delivers sustainable fiscal policy over the very long term.

A move to a more multi-polar reserve world could reduce long-term structural risks in the global economy



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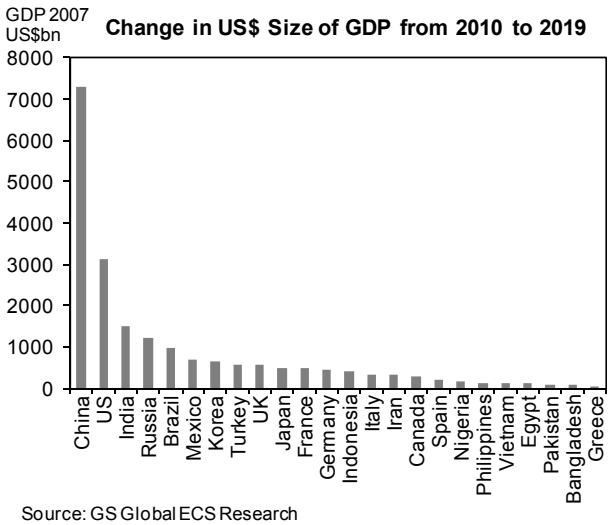

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Appendix 1

The following definitional aspects of the SDR are drawn from an IMF factsheet

The Role of the SDR

The SDR was created by the IMF in 1969 to support the Bretton Woods fixed exchange rate system. A country participating in this system needed official reserves—government or central bank holdings of gold and widely accepted foreign currencies—that could be used to purchase the domestic currency in foreign exchange markets, as required to maintain its exchange rate. But the international supply of two key reserve assets, gold and the US Dollar, proved inadequate for supporting the expansion of world trade and financial development that was taking place. Therefore, the international community decided to create a new international reserve asset under the auspices of the IMF.

However, only a few years later, the Bretton Woods system collapsed and the major currencies shifted to a floating exchange rate regime. In addition, the growth in international capital markets facilitated borrowing by creditworthy governments. Both of these developments lessened the need for SDRs.

The SDR is neither a currency, nor a claim on the IMF. Rather, it is a potential claim on the freely usable currencies of IMF members. Holders of SDRs can obtain these currencies in exchange for their SDRs in two ways: first, through the arrangement of voluntary exchanges between members; and second, by the IMF designating members with strong external positions to purchase SDRs from members with weak external positions. In addition to its role as a supplementary reserve asset, the SDR serves as the unit of account of the IMF and some other international organisations.

Basket of Currencies Determines the Value of the SDR

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 US Dollar. After the collapse of the Bretton Woods system in 1973, however, the SDR was redefined as a basket of currencies, today consisting of the Euro, Japanese Yen, Pound Sterling and US Dollar. The **US Dollar-value** of the SDR is posted daily on the IMF's website. It is calculated as the sum of specific amounts of the four currencies valued in US Dollars, on the basis of exchange rates quoted at noon each day in the London market.

The basket composition is reviewed every five years by the Executive Board to ensure that it reflects the relative importance of currencies in the world's trading and financial systems. In the most recent review (in November 2005), the weights of the currencies in the SDR basket were revised based on the value of the exports of goods and services and the amount of reserves denominated in the respective currencies which were held by other members of the IMF. These changes became effective on January 1, 2006. The next review will take place in late 2010.

The SDR Interest Rate

The SDR interest rate provides the basis for calculating the interest charged to members on regular (non-concessional) IMF loans, the interest paid to members on their SDR holdings and charged on their SDR allocations, and the interest paid to members on a portion of their quota subscriptions. The SDR interest rate is determined weekly and is based on a weighted average of representative interest rates on short-term debt in the money markets of the SDR basket currencies.

SDR Allocations to IMF Members

Under its Articles of Agreement, the IMF may allocate SDRs to members in proportion to their IMF quotas. Such an allocation provides each member with a costless asset. However, if a member's SDR holdings rise above its allocation, it earns interest on the excess; conversely, if it holds fewer SDRs than allocated, it pays interest on the shortfall.

There are two kinds of allocations:

General allocations of SDRs. General allocations have to be based on a long-term global need to supplement existing reserve assets. Decisions to allocate SDRs have been made three times. The first allocation was for a total amount of SDR9.3bn, distributed in 1970-72 in yearly instalments. The second allocation, for SDR12.1bn, was distributed in 1979-81 in yearly instalments.

The third general allocation was approved on August 7, 2009 for an amount of SDR161.2bn and took place on august 28, 2009. The allocation increased simultaneously members' SDR holdings and their cumulative DR allocations by about 74.13% of their quota.

Special allocations of SDRs. A proposal for a special one-time allocation of SDRs was approved by the IMF's Board of Governors in September 1997 through the proposed Fourth Amendment of the Articles of Agreement. Its intent is to enable all members of the IMF to participate in the SDR system on an equitable basis and correct for the fact that countries that joined the Fund after 1981—more than one-fifth of the current IMF membership—had never received an SDR allocation.

The Fourth Amendment became effective for all members on August 10, 2009 when the Fund certified that at least three-fifths of the IMF membership (112 members) with 85% of the total voting power accepted it. On August 5, 2009, the United States joined 133 other members in supporting the Amendment. The special allocation was implemented on September 9, 2009; it increased members' cumulative SDR allocations by SDR21.5bn using a common benchmark ratio as described in the amendment.

Buying and Selling SDRs

IMF members often need to buy SDRs to discharge obligations to the IMF, or they may wish to sell SDRs in order to adjust the composition of their reserves. The IMF acts as an intermediary between members and prescribed holders to ensure that SDRs can be exchanged for freely usable currencies. For more than two decades, the SDR market has functioned through voluntary trading arrangements. Under these arrangements a number of members and one prescribed holder have volunteered to buy or sell SDRs within limits defined by their respective arrangements. Following the 2009 SDR allocations, the number and size of the voluntary arrangements has been expanded to ensure continued liquidity of the voluntary SDR market.

In the event that there is insufficient capacity under the voluntary trading arrangements, the Fund can activate the designation mechanism. Under this mechanism, members with sufficiently strong external positions are designated by the Fund to buy SDRs with freely usable currencies up to certain amounts from members with weak external positions. This arrangement serves as a backstop to guarantee the liquidity and the reserve asset character of the SDR.

Appendix 2

The offshore CNY market in Hong Kong and the pilot project for CNY trade finance

Hong Kong's vision to become the world's offshore CNY centre can play a critical part in China's exchange rate reform and the internationalisation of the CNY.

China has already nominated Hong Kong as an offshore CNY centre. We believe London's experience in establishing itself as the leading Eurodollar centre offers a good template for Hong Kong to pursue its goal.

China's trade deficit with Asia, given the closely-knit intra-regional supply chain, would allow more CNY transactions to take place in Hong Kong.

The internationalisation of the CNY is a critical part of China's capital account liberalisation and its exchange rate reform. The liberalisation of its capital account and the associated exchange rate reforms are important economic and political agendas for China. The benefits of CNY internationalisation are:

- Denominating the transactions in CNY would significantly reduce the exchange rate risks of Chinese exporters and importers. If China wants to allow more exchange rate flexibility, it needs to allow its exporters to hedge their currency exposures—one way to do that is to allow them to denominate exports in CNY, but that requires an offshore CNY market so that importers can hold CNY before paying for exports.

- Greater recognition of the CNY globally would also enhance the competitiveness of China's financial institutions, as China prepares to liberalise its capital account and Chinese financial institutions venture offshore.

- Greater regional cooperation within Asia. Asia is China's largest trading partner.

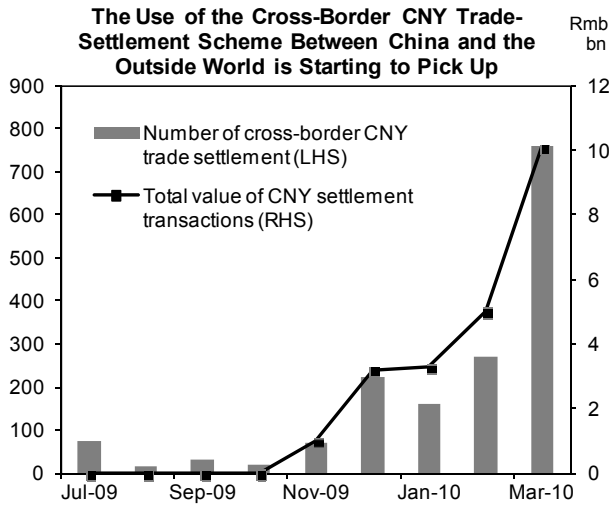
- Chinese monetary authorities would reap the benefits via seigniorage.

- Increased status for the CNY, supporting the case for a greater weight in the SDR and, hence, greater representation in global economic policies. Promoting a more comprehensive inclusion of currencies in the SDR would likely help diversify FX risks for asset and liability holders by reducing the risk of reliance on the USD.

However, the existing capital controls in China limit the usage of the CNY outside of China's monetary system. Given that the CNY is not a fully convertible currency, transactions in CNY-denominated trade and investments are constrained. The CNY in circulation in Hong Kong is now only around 1.3% of total deposits, perhaps partly because there are still insufficient CNY-denominated assets for Hong Kong banks to hold to generate returns and relatedly, the interest rate payable on CNY deposits is very low.

With the opening up of capital controls in China still at a very early stage, we believe the best way to encourage the usage of the CNY would be via an offshore CNY centre. An offshore CNY centre, free of capital controls, provides a platform for CNY transactions to take place.

The Chinese government has already specifically nominated Hong Kong as an offshore CNY centre. Back in 2003, Hong Kong banks were allowed to conduct personal CNY business, which made way for the creation of CNY



Source: GS Global ECS Research

deposit businesses in Hong Kong. The CNY was already used by the large number of mainland Chinese tourists flooding into Hong Kong after the introduction of the Individual Visitors' Scheme (IVS). In 2007, the PBoC and the National Development and Reform Commission (NDRC) announced rules governing the issuance of CNY-denominated bonds in Hong Kong, which marked the beginning of a CNY-denominated capital market. To strengthen the support for CNY businesses in Hong Kong, the PBoC signed a swap agreement with the HKMA in 2008, committing to the provision of short-term liquidity support for the Hong Kong banking system in handling CNY-denominated transactions. Although the scale of these measures was small initially, they have been significant in giving Hong Kong a head-start in becoming an offshore CNY centre. Lastly, in December 2009, Premier Wen Jiabao gave his direct support for Hong Kong's aspirations to become an offshore CNY centre.

Thanks to Enoch Fung and Shirla Sum for their contribution to this Appendix. For more detail, see their paper , "**Hong Kong: Building Out to Become an Offshore CNY Centre*****", also published today.***

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