Grand bargain shaping up between China, US and IMF

Pragmatic steps on bringing renminbi into SDR

by David Marsh

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A ‘grand bargain’ between China, the US and the International Monetary Fund seems to be shaping up under which Beijing may be about to enter the heart of global finance in exchange for turning the renminbi into a strong currency on world financial markets.

The People’s Bank of China has been drawing on its $3.8tn of currency reserves in intervention to keep the renminbi reasonably stable against the strong dollar, propelling the Chinese currency to a real (inflation-adjusted) trade-weighted appreciation of 11% during the past 12 months. This exceeds the 9% real appreciation of the dollar. The intervention reinforces the Chinese authorities’ attempts to maintain favour with important foreign holders of renminbi, including many international central banks, even though Beijing is vulnerable to the resulting loss of export competitiveness.

The Chinese actions appear linked to an attempt to underline the currency’s fitness to join the Special Drawing Right, the IMF’s ubiquitous composite currency used in official financing and reserves. Although nothing has been confirmed, and final outcomes could become embroiled in international politics, China appears broadly on track to become part of the IMF’s official currency unit in a review process due to be completed later this year. This would represent a landmark move for an emerging market currency to join a monetary unit hitherto encompassing solely industrialised nations.

The IMF seems to be taking a pragmatic line on the contentious issue of a new structure for the SDR, which could involve bringing in the renminbi despite its formal lack of full convertibility. All of this is a potential challenge for the dollar and its pivotal position in world money. It adds up to an element of weakness for the euro, which has been losing ground as a reserve unit following action by the European Central Bank to weaken the single European currency as part of efforts to revive the euro area economy.

In a fundamental departure for central bank governors, who normally refrain from giving guidance on foreign exchange rates or commenting on other central banks’ actions, Mario Draghi, the ECB president, said last August: ‘The fundamentals for a weaker exchange rate are today much better than they were two or three months ago... Other central banks have been reducing their exposure to the euro.’

Over the past 12 months, euro area countries have recorded a real trade-weighted devaluation of 12%, according to data from the Bank for International Settlements. The movement has accelerated since the ECB started large purchases of government bonds earlier this month, much of which involves encouraging foreign official holders to sell their euro reserves, often being exchanged for dollar assets.

China has not mounted an open campaign to enter the SDR, established in 1969, which at present groups the main reserve currencies, the dollar, euro, yen and sterling, and is valued at around $1.36. This is well down from $1.5 towards the end of last year, a result of US currency strength. Beijing may be calculating that, if it can maintain currency stability, it could advocate the renminbi’s adhesion to the SDR as a means of strengthening the otherwise weakening composite unit. China is also garnering potential support from the US Treasury and Congress which otherwise in recent years have been quick to condemn Beijing for alleged ‘manipulation’ in weakening its currency to raise export competitiveness – the opposite of what has been happening in the last few months.

An additional factor building momentum towards revitalising the SDR is China’s action to galvanise leading emerging market economies towards reforming word monetary arrangements. This includes the five nation Brics group’s decision to set up the New Development Bank in Shanghai, partly as a challenge to the IMF and the World Bank. China this month has achieved significant success in persuading leading European countries to join its planned Beijing-based Asian Infrastructure Investment Bank in spite of US opposition.

The IMF’s review of the options for widening the SDR examines as important conditions the renminbi’s much-increased use in trade invoicing as well as whether it is ‘freely usable’ in international payments and asset management. Other indicators under the spotlight include use of the renminbi in international debt securities and bank liabilities, and foreign exchange spot market turnover. In all these areas the renminbi, although affected by residual capital account restrictions, has made impressive strides in the last two years.