The yuan in the SDR: From base to gold

The IMF gives its blessing to China's controlled currency

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WHEN Marco Polo travelled to China in the 13th century, he found that among its wonders was "the secret of the alchemists". Its imperial court could turn mulberry bark into money. It simply printed paper notes, decreed that people must accept them and killed counterfeiters. For a Venetian used to gold coins, the world's first fiat currency was a marvel. Its value derived not from precious metal but from the credibility of the regime issuing it. This month China achieved another kind of monetary alchemy: to fashion a global reserve currency out of one that, by a range of criteria, does not yet merit such status.

On October 1st the yuan became the fifth entrant in the basket of currencies that forms the Special Drawing Right, a reserve asset created by the IMF. Immediate implications are limited. SDRs are a unit of account, not a real currency; inclusion in the basket does not force anyone to acquire the yuan. Symbolically, though, it is a big deal: the IMF's seal of approval for China's monetary system. It has deemed it safe for central banks around the world to add the yuan to their reserves. Dozens of central banks in fact already do so, with about 1% of global reserves now held in yuan. SDR status should add momentum.

This is a remarkable achievement for China. Typically, reserve currencies are issued by countries that have large economies, flexible exchange rates, open capital accounts and deep financial

markets. China certainly meets the first requirement of size, but the others are works in progress. Nevertheless, the IMF judged that China had done enough to make the yuan usable, notably by opening its bond market to foreign institutions and shifting to a slightly more market-oriented exchange rate.

In “Gaining Currency”, a book about the yuan’s rise, Eswar Prasad of Cornell University looks at China’s tactics. A series of careful initiatives—trade invoicing, overseas loans and swaps with other countries—have nudged the yuan into global markets. It now accounts for about 2% of global cross-border payments, up from virtually zero five years ago, making it the fifth-most used currency.

Unquestionably, politics also played a part in the decision. China had lobbied for SDR inclusion. It was a way for the IMF to acknowledge its real, if gradual, progress in financial reforms. There was also an element of anticipation: should China continue on its development path, the yuan’s global importance is sure to increase.

The irony of the yuan’s ascendancy in the IMF’s books is that it comes after a year when, for the market, the Chinese currency was on the decline. A small devaluation of the yuan in August 2015, partly to make it more flexible, set off a storm of speculation that China wanted a much bigger devaluation to support its slowing economy. Companies and investors bet against the yuan in large numbers. To defend it, China’s central bank has tightened capital controls and burnt through nearly $500 billion of its reserves over the past year.

The gap between the fears and hopes surrounding the yuan can sometimes seem like a chasm. To optimists, it will soon rival the dollar. To pessimists, it is only a matter of time before it resumes its descent. In truth the two are not necessarily contradictory; the dollar is the world’s leading currency but it still goes through regular bouts of depreciation.

Yet there is also a big difference between being a reserve currency and being the world’s pre-eminent currency. As Mr Prasad argues, China’s controlled approach could soon reach its limits. Ultimately, for the yuan really to challenge the dollar, China must win trust as a safe haven for assets. It will not only need deeper, more open financial markets; it will also need an open political system, governed by rule of law. That transition would be alchemy of a different kind.