The Economist, December 5th, 2015

The yuan joins the SDR

Maiden voyage

Reserve-currency status might make for a weaker yuan

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PASSING through the Suez Canal became easier earlier this year, thanks to an expansion completed in August. Now it is about to become a little bit more complicated. Transit fees for the canal are denominated in Special Drawing Rights, a basket of currencies used by the International Monetary Fund (IMF) as its unit of account. This week the IMF decided to include the yuan in the basket from next year, joining the dollar, the euro, the pound and the yen.

If lots of things were priced in SDRs, the IMF's decision would have forced companies around the world to buy yuan-denominated assets as soon as possible, to hedge their exposure. That would have prompted China's currency to strengthen dramatically. But few goods or services are priced in SDRs. Instead, admission to the currency club is significant mainly for its symbolism: the IMF is lending its imprimatur to the yuan as a reserve currency—a safe, liquid asset in which governments can park their wealth. Indeed, far from setting off a groundswell of demand for the yuan, the IMF's decision may pave the way for its depreciation.

The reason is that the People's Bank of China (PBOC) will now find itself under more pressure to manage the yuan as central banks in most rich economies do their currencies—by letting market forces determine their value. In bringing the yuan into the SDR, the IMF had to determine that it is "freely usable". Before coming to this decision, the IMF asked China to make changes to its currency regime.

Most importantly, China has now tied the yuan's exchange rate at the start of daily trading to the previous day's close; in the past the starting quote was in effect set at the whim of the PBOC, often creating a big gap with the value at which it last traded. It was the elimination of this gap that lay behind the yuan's 2% devaluation in August, a move that rattled global markets. Though the yuan is still far from being a free-floating currency—the central bank has intervened since August to prop it up—the cost of such intervention is now higher. The PBOC must spend real money during the trading day to guide the yuan to its desired level.

Inclusion in the SDR will only deepen the expectations that China will let market forces decide the yuan's exchange rate. The point of the SDR is to weave disparate currencies together into a single, diversified unit; some have suggested, for example, that commodities be quoted in SDRs to reduce the volatility of pricing them in dollars. But if China maintains its de facto peg to the dollar, the result of adding the yuan to the SDR will be to boost the dollar's weight in the basket, defeating the point.

What would happen if China really did give the market the last word on the yuan? For some time it has been under downward pressure. The simplest yardstick is the decline in China's foreign-exchange reserves, from a peak of nearly $4 trillion last year to just over $3.5 trillion now—a reflection, in part, of the PBOC's selling of dollars to support the yuan. Were it not for tighter capital controls since the summer, outflows might have been even bigger.

And the yuan does look overvalued. Despite China's slowing economy, its continued link to the surging dollar has put it near an all-time high in trade-weighted terms, up by more than 13% in the past 18 months (see chart). With the Federal Reserve gearing up to start raising interest rates at the same time as China is loosening its monetary policy, the yuan looks likely to come under more downward pressure, at least against the dollar.

It would be foolhardy to predict that China will suddenly give the market free rein. That would go against its deep-seated preference for gradual reform. But while basking in the glow of its SDR status, China must also be aware of the responsibility to minimise intervention that comes with it. A weaker yuan may well be the result.