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Clarifying the Concept of Reserve Assets and Reserve Currency

Prepared by the Statistics Department

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CLARIFYING THE CONCEPT OF A RESERVE CURRENCY[1]

The recent discussions on the SDR valuation has highlighted the need to clarify the sixth edition of IMF's Balance of Payments and International Investment Position Manual (BPM6) concept of reserve currencies against the "freely usable" concept as stated in Article XXX (f) of the IMF's Articles of Agreement, and for a framework to assess whether a currency meets the requirements of a reserve currency. The paper addresses these issues and proposes a four-step approach for determining reserve currencies in the context of the survey on the Currency Composition of Foreign Exchange Reserves (COFER). Committee members are asked to comment and provide views on the proposals set out ahead.

I. CONTEXT

1. The IMF is currently conducting the quinquennial review of the methods of valuation of the SDR basket, including its currency composition. Under the SDR valuation framework, currencies in the SDR basket need to be determined by the IMF's Executive Board to be freely usable currencies, as per Article XXX (f) of the IMF's Articles of Agreement.[2] In contrast, *BPM6* requires that reserve assets must be denominated and settled in a convertible foreign currency.[3] So the question has been asked: what is the difference between convertible currencies and freely usable currencies for reserve asset purposes?

2. In addition, users and compilers of data on reserve assets have been asking for practical guidance from IMF staff on how to determine reserve currencies and querying whether a list of reserve currencies exists. Typically the staff of the IMF's Statistics Department (STA) draws on the definition and description of reserve currencies in *BPM6* and the text of the *Reserve Template Guidelines*. To date, all currencies included in the SDR basket are considered reserve currencies along with some currencies that are outside of the SDR basket as reflected in the COFER list of currencies separately identified.

3. The determination of reserve currencies is important for the IMF, both in its surveillance work, such as Article IV missions, and for assessing gross international reserves in the context of IMF programs. Further, the IMF Statistics Department (STA) frequently receives questions regarding the eligibility of currencies for reserve asset purposes.

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[1] Prepared by Paul Austin, Antonio Galicia-Escotto, Joji Ishikawa, and Tamara Razin, Balance of Payments Division, STA.

[2] For a survey of the evolving landscape of international currencies, see Maziad *et al* (2011) "*Internationalization of Emerging Market Currencies: A Balance Between Risks and Rewards*." IMF Staff Discussion Note, SDN/11/17, October 2011.

[3] In 1978, the Second Amendment of the IMF's Articles of Agreement entered into effect and the concept of "convertible currencies" was replaced by the term "freely usable currency."

II. Reserve Assets

4. According to the *BPM6*, "*reserve assets are those external assets that are readily available to and controlled by monetary authorities for meeting balance of payments financing needs, for intervention in exchange markets to affect the currency exchange rate, and for other related purposes (such as maintaining confidence in the currency and the economy, and serving as a basis for foreign borrowing).*" Main attributes that would qualify an asset as reserve assets are: the asset should actually exist and it should be an external asset, be under effective control of monetary authorities, and be readily available. While most of these attributes can be easily determined, the *readily available* needs further consideration.

III. Concepts of Currency Convertibility and Freely Usable

5. To *be readily available* in unconditional form for balance of payments purposes, a reserve asset must be liquid and denominated in a convertible currency. Liquidity is required so that the asset can be bought, sold for foreign currency (cash) with minimum cost and time, and without unduly affecting the value of the asset—that is there needs to be a liquid and deep market for these assets and no major restrictions impeding such transactions. Convertibility, defined in *BPM6* as freely usable for settlements of international transactions, is required so that a reserve currency can be exchanged in the markets for another currency needed for balance of payments purposes, again with minimum cost and time and without substantial adverse exchange rate effect. This is because a country facing balance of payments needs must be able to use any currency in its reserve asset portfolio to meet settlement needs in any other currency or currencies. Currency convertibility in the context of reserve assets means exchangeability of that currency to other currencies.

6. In reality, central banks and other reserve asset holders have *de facto* determined what is a reserve currency through the composition of currencies held in the reserve assets: 97 percent of foreign currency reserves are held in the seven currencies separately identified in the survey of COFER, all of which are widely regarded as convertible currencies.[4]

7. The freely usable concept was developed for and plays a key role in IMF operations.[5] That is, freely usable currencies reduce the potential risks and costs for members receiving and using currencies in transactions with the IMF. IMF staff interprets a "freely usable currency "as that guided exclusively by the purpose for—and the context within—which it is established under the Articles of Agreement; namely, as an integral element of the

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[4] The COFER survey has close to 60 percent coverage of the world's foreign exchange reserves. The extent to which the currency composition of the world's total foreign exchange reserves differs from the COFER survey would depend on the extent to which the currency composition of foreign exchange reserves of non-reporters to the COFER survey differs from that of reporters to the COFER survey.

[5] *Review of the Method of Valuation on the SDR-Initial Considerations,* FO/DIS/15/116.

framework that enables the IMF to provide temporary balance of payments assistance to member countries."[6]

8. As per the Articles of Agreement, a freely usable currency is one that is determined to be **widely used** to make payments for international transactions and **widely traded** in the principal exchange markets.[7] Under the context of the SDR review, the discussion on these criteria has focused on four indicators of currency use and tradability: international banking liabilities as measured by the BIS, official foreign exchange reserves measured by the COFER survey,[8] international debt securities measured by the BIS data, and foreign exchange turnover measured by BIS triennial survey supplemented with semi-annual surveys by most of the centers with the largest foreign exchange turnover. Although complementary indicators have been used in the current review of the SDR basket, any final decision on whether a currency is freely usable under the Articles of Agreement is a policy judgment call by the IMF Executive Board that also takes into account the operational needs of the IMF, IMF members, and other SDR holders.

9. So while being close, the *BPM6* concept of convertibility (freely usable for settlement of international transactions) and the SDR concept of freely usable (widely used and widely traded) are not synonymous. Indeed, the August 4, 2015 IMF factsheet "Review of the Special Drawing Rights (SDR) Currency Basket" noted that a currency can be widely used and widely traded even if it is subject to some capital account restrictions; on the other hand, a currency that is convertible is not necessarily widely used and widely traded. Nonetheless, the widely traded criteria indicates that a currency *can be exchanged in markets for another currency to meet the member's balance of payments need with reasonable assurances of no substantial adverse exchange rate effect.*[9] Therefore, it is plausible to consider that the IMF operational definition of freely usable also implies convertibility.

IV. Assessing Reserve Currency

10. At present, STA does not have specific criteria for assessing a currency as a reserve currency. But a currency that has markets with sufficient depth and liquidity to allow the conduct of sound and efficient transactions for instruments denominated in that currency, can

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[6] *Ibid*, p. 10

[7] This is based on the definition in the Articles of Agreement XXX (point (f)).

[8] For the 2015 SDR valuation review, STA also conducted a "Survey on the Holdings of Currencies in Official Foreign Currency Assets" for end-2013 and end-2014. Both official reserve assets and other foreign currency assets (both claims on non-residents and residents) were covered. The results are available at http://www.imf.org/data.

[9] *Review of the Method of the Valuation of the SDR – Initial Considerations*, IMF, 2015, Paragraph 21.

be freely exchanged for other currencies, and is held by a broad range of monetary authorities in significant amounts, has traditionally been regarded as a reserve currency.

11. STA has used triennial surveys of currencies held by monetary authorities to identify currencies that monetary authorities use for managing their portfolio of reserve assets. For example, in 2011, two currencies (Australian Dollars and Canadian Dollars) were identified as being widely accepted by monetary authorities as reserve currencies. After consultation with the IMF's Executive Board, these two currencies were separately identified in the quarterly COFER survey.

12. Going forward, STA is considering the following four-step approach for determining reserve currencies.

- ***Gauging Acceptance by the Monetary Authorities***: STA proposes to replace the triennial survey of currencies held with a survey on holdings of currencies in official foreign currency assets, also to be conducted every three years. This survey, based on that conducted in 2015, and which can be named Survey of Currency Composition of Official Foreign Currency Assets (OFCA survey), will cover separately the currency composition of foreign exchange assets to gauge the amount of holdings of a currency in reserve assets, as well as the currency composition of other foreign currency assets of monetary authorities. As with the survey in 2015 more currencies will be separately identified than for the COFER survey, but, like the COFER survey, the currency composition of foreign exchange reserves should total to that reported to the IMF for *International Financial Statistics*. This triennial survey will provide evidence of any significant shifts in currency composition of foreign exchange reserves over a medium-term period.

- ***Developing Criteria and Consulting IMF Departments:*** STA proposes to develop more specific criteria to identify a reserve currency. Drawing on the OFCA survey to identify currencies for which there is growing evidence of broad acceptance by monetary authorities, STA will consult other relevant IMF departments, including the relevant Area Department on whether a currency can be deemed as fulfilling the conditions of a convertible currency for reserve purposes using the specific criteria developed. In addition to evidence of broad use, the initial thinking is that the more specific criteria should focus on the depth, liquidity, and accessibility of domestic markets as well as the extent of any restrictions that preclude the currency from being exchanged for other currencies to meet a member's balance of payments need. The criteria should remain objective and remain stable over time. There should also be a process for monitoring whether a reserve currency so determined continues to comply with the criteria.

- ***Consultation with the IMF's Executive Board on Currency's Inclusion in the Quarterly COFER Survey:*** If a currency is determined to be a reserve currency, STA would consult the IMF's Executive Board on its intent to separately identify the currency in the quarterly COFER survey.

- ***Inclusion in the Quarterly COFER:*** Currencies separately identified in the COFER survey will serve as guidance for a list of reserve currencies.

The above four steps are intended to ensure that the process of determining a reserve currency by STA staff is objective, broadly quantitative, evenhanded, and stable over time.

Questions for the Committee:

1. Do Committee members agree with the approach to identifying reserve currencies set out above?

2. Do Committee members agree that the specific criteria should focus on the characteristics set out in paragraph 12 (bullet 2) – e.g., depth, liquidity and accessibility of domestic markets and exchangeability of the currency in foreign exchange markets?

3. Do Committee members suggest any other specific criteria to assess whether a currency is a reserve currency?