Renminbi's SDR inclusion: Long-term positive but not a game changer

China's renminbi (RMB) has become the fifth currency to join the International Monetary Fund's "Special Drawing Rights" (SDR) basket of reserve currencies. Some analysts have been quick to hail the development as proof that the RMB is close to becoming the next global reserve currency. In this note, Manulife Asset Management's Megan Greene, Chief Economist, Paula Chan, Chinese bond market specialist and Kai Kong Chay, Greater China equity specialist share their views on the short- and long-term implications of the development.

The IMF has finally agreed to include the renminbi (RMB) in its Special Drawing Rights (SDR)[1], the pursuit of which has arguably driven a number of Chinese policies over the past year. Some analysts are hailing this development as the RMB's biggest step towards being the global reserve currency[2]. But being part of the SDR is neither sufficient nor even necessary for the RMB to become the global reserve currency. Nor does China need to aspire to have a global reserve currency to wield international influence.

What does SDR inclusion mean?

To determine the importance of the RMB's inclusion in the SDR, it is important to know what SDRs are used for. The SDR is a basket of currencies – previously consisting of the US dollar, the euro, the British pound and the Japanese yen – held by IMF member states[3]. If a country gets into a balance of payments crisis, it can sell SDRs to other members in exchange for any currency in the basket.

To be included in the SDR, a currency must be "widely used" and "freely usable"[4]. The RMB qualified for the former years ago, given China's role as one of the biggest traders globally. But the RMB is neither fully convertible nor free-floating and is subject to capital controls and open market operations. As a result there has been some question over its qualification as "freely usable", though this was presumably laid to rest when the IMF agreed to add the RMB to the SDR basket on 30 November.

According to Megan Greene, Chief Economist with Manulife Asset Management, "SDR inclusion means that China finally gets to sit at the big kids table of currencies. Some analysts have claimed this means the RMB is well on its way to being the global reserve currency. It is at the very least a symbolic nod of approval for the currency and for the measures the Chinese government has implemented to try to qualify for the SDR. But I doubt SDR inclusion will have much impact on the RMB's status as a potential reserve currency."

Not such a big deal after all

First, SDRs make up less than 4%[5] of the non-gold global official foreign exchange reserves, even after they were beefed up in the wake of the global financial crisis. There is no liquid private market in SDR assets, and they must be broken down into the currencies comprising them to be used to buy any other assets. Being part

[1] IMF: IMF's Executive Board Completes Review of SDR Basket, Includes Chinese Renminbi, 30 November 2015
[2] Barron's Blog: China – Yuan Will Replace US Dollar? 16 November 2015
[3] IMF: Questions & Answers - Special Drawing Right (SDR) Allocations, 5 August 2013
[4] IMF: Fact Sheet - Review of the Special Drawing Right Currency Basket, 30 November 2015
[5] IMF: IMF 2015 Annual Report 2015, Appendix, Table 1.1

of the SDR is not the end-all-and-be-all for currencies. A currency does not even have to be in the SDR to be a reserve currency – the Swiss franc is a case in point. Finally, central banks consider a currency a reserve currency when it can be sold freely into a deep and liquid market. This is far more important to central banks and fund managers alike than membership in an exclusive currency club.

Now that China has achieved its goal of RMB SDR inclusion, there is a chance that it will stall on further reforms to open up the capital account. This is particularly the case because opening up the capital account involves the trilemma dilemma – China would like to see interest rates fall and the RMB depreciate, but cannot do so while opening up the capital account without sparking significant capital controls. It seems likely that one way for the Chinese government to handle this is to slow down on opening up the capital account. The Chinese government is committed to a fully-convertible and freely-floating RMB, but we think it will happen much more slowly than most analysts expect.

Finally, the RMB has been and can continue to be internationalised without being in the SDR. This summer, following Chinese President Xi Jinping's visit to London, the city announced it will be the first overseas financial centre to issue Chinese sovereign debt in RMB[6]. China has also set up swap agreements with a number of other countries so that trades can be settled in RMB. According to the clearing system Swift, the RMB has outstripped the yen, US dollar and Hong Kong dollar as the main currency for payments between China and Asia-Pacific countries[7]. The RMB also surpassed the Japanese yen to rank fourth behind the US dollar, euro and British pound in global payments in August of this year[7].

Greene explained, "The RMB does not have to be the global reserve currency to exert international influence. It just has to be important enough for a number of countries to be reliant on RMB clearing systems and depositories. Once other countries are reliant on using RMB post-trade infrastructure, the Chinese government has the ability to grant or deny access to it. Being the number one currency needn't be the goal. Being number four may well be good enough."

Exchange rate implications: Further RMB volatility expected

Market attention has not only been focused on the RMB due to anticipation of the IMF's SDR decision. Indeed, the RMB has been consistently in the headlines since the People's Bank of China (PBoC) unexpectedly weakened the currency on 11 August 2015, lowering its official fixing rate almost 2% overnight.

While the RMB actually lost 0.47%[8] versus the US dollar on news of the IMF decision, Paula Chan, Senior Portfolio Manager and Chinese bond market specialist, does not expect the SDR inclusion to drive significant RMB movement in the near term. According to Chan, "The RMB's addition to the SDR actually could lead to a higher degree of two-way exchange rate volatility as the fixing mechanism becomes more transparent and market forces begin to play a higher role in setting its value. One significant factor affecting the exchange rate will be the pace at which the Chinese government progresses with internationalising the RMB and opening its capital account – the more freely the currency can change hands the more likely it is that international flows will impact its value."

Additionally, as Megan Greene noted earlier, IMF member states can use SDRs as a tool when facing a "balance of payments" crisis. Inclusion in the SDR basket means that China will share some of the risk for IMF programme countries that need a bailout. For this reason – among others – Greene expects the RMB to depreciate gradually going forward, over the longer term.

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[6] Reuters: China Central Bank Launches Debut Dim Sum Bond in London, 20 October 2015
[7] Swift: Chinese Yuan demonstrates strong momentum to reach #4 as an international payments currency, 6 October 2015
[8] Bloomberg, 1 December 2015

SDR addition points to larger role for RMB bonds in global portfolios

As pointed out earlier, in many ways the RMB's addition to the SDR is not really such a big deal in the short term. That being said, it does signal continuing maturation of RMB-denominated capital markets. Indeed, in the long-term Paula Chan believe the SDR inclusion is a positive for China's fixed income market.

According to Chan, "While the SDR inclusion will trigger relatively modest flows of RMB into global SDR accounts – anecdotal reports suggest 70 global central banks will shift about 10% of their reserves into RMB-denominated bond holdings by 2025 – it marks a significant vote of confidence in the stability and reliability of the RMB itself and RMB-denominated assets. In a way it can be considered an endorsement of the RMB as a unit of account and thus support its wider adoption for trade settlement, financial transactions and investment.

"Indeed, we have frequently commented that we see a time when a portion of every global multi-asset investment portfolio in the world will be denominated in RMB, and we believe SDR inclusion marks a signpost on the road to this future."

Chinese equities to benefit as SDR joins "One Belt, One Road" in driving RMB acceptance

This tacit endorsement of the RMB can also be considered a long-term positive for Chinese equity investment. According to Kai Kong Chay, Senior Portfolio Manager and Greater China equity specialist with Manulife Asset Management, "The RMB's addition to the SDR should not be looked at in isolation, but should be considered in the context of other developments as China moves to reform and open its economy."

Chay believes the SDR inclusion is just one of several ways that the currency's role in global trade, finance and investment is growing. He cites China's unfolding "One Belt, One Road" (OBOR) plan to revive its ancient trade links to Europe by reviving land and sea trading routes as another example of how the currency is increasing in visibility – and one that is likely to have more immediate impact. This is borne out by the numbers, with China's overseas investment flow having climbed 16.3% to US$92.5 billion in the first 10 months of 2015 alone – a significant increase but just a drop in the bucket compared to the US$890 billion worth of OBOR projects that are underway or planned[9].

Chay explains that the lion's share of this investment will likely be spent on contracts awarded to Chinese companies and in many cases involving a large share of Chinese labour. "Construction companies, financial institutions underwriting projects, logistics services providers and even domestic consumption should benefit from the significant capital expenditures expected to implement the OBOR initiative.

"As the OBOR initiative and the RMB's addition to the SDR come alongside significant progress on opening China's capital markets to international investment – including increases to overseas investment quotas such as the Qualified Foreign Institutional Investment (QFII) scheme and the Shanghai-Hong Kong Stock Connect scheme – we see increasing opportunities for foreign investors to benefit."

However, like Greene and Chan, Chay cautions that this is a long-term trend and that he does not see a call for significant changes to investment allocations based on the RMB's addition to the SDR. "We continue to select investments based on bottom-up analysis and this development, while positive, does not change the fortunes of individual companies or sectors overnight."

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[9] FT: One Belt, One Road set to turbocharge renminbi usage, 30 November 2015