Investment Note

Manulife Asset Management

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RMB inclusion into the SDR: Not if but when

Paula Chan, Senior Portfolio Manager and Chinese bond market specialist with Manulife Asset Management shares her views on the potential for renminbi inclusion in the International Monetary Fund's special drawing rights (SDR) basket and broader investor implications of the RMB potentially emerging as a reserve currency in the future. While we do not believe the RMB will strengthen significantly against the broad major currencies as a result of SDR inclusion, it marks a further step towards currency internationalisation.

As China continues firmly on the path towards RMB internationalisation, authorities have been actively campaigning for its currency to be included in the International Monetary Fund's (IMF) special drawing rights (SDR) basket.

The SDR is an international reserve asset created by the IMF for use by its members to supplement their official reserves. Members can swap their foreign currency reserves for the liquid currencies in the SDR basket in times of crisis. Though not widely used, inclusion in the basket would be a symbolic milestone for the RMB, giving it foreign reserve status and recognition that the currency is close to being fully internationalised and freely used.

The SDR basket is reviewed every five years and the IMF is expected to make a decision in November 2015 on whether to add the RMB to the four currencies already in the basket. The decision is made by the IMF Executive Board, through a vote.

Based on the last review conducted in November 2010, the SDR basket is weighted as follows: US dollars (41.9%), euros (37.4%), pounds sterling (11.3%) and the Japanese yen (9.4%)[1]. The weights assigned to each currency in the SDR basket are adjusted to take into account their current prominence in terms of international trade and national foreign exchange reserves. According to estimates from HSBC, the RMB would have a potential weighting of around 14% if included in the SDR basket[2].

A question of when

In March this year, IMF Managing Director Christine Lagarde said it was a question of when, not if, the RMB would be included in the SDR basket[3]. The IMF has two criteria for inclusion in the SDR basket: currencies whose exports of goods and services during the five-year period ending 12 months before the review date had the largest value; and which have been determined by the IMF to be "freely usable" currencies. In the IMF's 2010 review, the RMB was deemed to have met the first criteria but fell short of being "freely usable". So what are the RMB's chances for inclusion in 2015?

We believe that the RMB has a strong case for inclusion this time around. In November 2014, it became the fifth most actively used currency in global payments, behind the US dollar, euro, pound and yen[4]. The second criteria has also been met to some extent, however it will be up to the IMF to determine whether the RMB is "freely usable".

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[1] http://www.imf.org/external/np/sec/pr/2010/pr10434.htm
[2] HSBC Global Research, *RMB and the SDR: The top 10 questions*, 15 April 2015.
[3] http://uk.reuters.com/article/2015/03/20/uk-china-imf-idUKKBN0MG0YJ20150320
[4] http://www.swift.com/about_swift/shownews?param_dcr=news.data/en/swift_com/2015/PR_RMB_into_the_top_five.xml

Indeed China has already taken a number of reforms to support wider RMB use, says Paula Chan, Senior Portfolio Manager and Chinese bond market specialist with Manulife Asset Management.

“To date, 12 countries have reached agreements with China to establish RMB clearing banks. China’s capital market is also opening up to global investors at an increasing pace, through the Qualified Foreign Institutional Investor (QFII) and RMB Qualified Foreign Institutional Investor (RQFII) programs and the more recently established Hong Kong Shanghai Stock Connect scheme. China’s bond market is currently over US$5 trillion, representing the largest bond market in Asia ex-Japan. Ongoing interest rate liberalisation and a wider trading band for the currency since early 2014 are also examples of wider market reform,” says Chan.

“Even if China does not achieve SDR status this year, we believe the RMB will eventually become a component of the SDR due to its rising importance from a global economic and asset class investment perspective. We expect China to take measures to further open up the onshore bond market, integrate with the offshore bond market and to provide foreign central banks with access and instruments to invest their foreign reserves,” explained Chan.

“On the currency front, we do not believe the RMB will strengthen significantly against the broad major currencies as a result of SDR inclusion. However, this will allow more central banks to hold the currency as it gains foreign reserve status, in turn, facilitating still wider RMB use for trade and financial transactions.

“We may also see increased volatility in the currency as it moves towards further internationalisation, but this will also mean more transparency. Global equity and bond indices may also move to include RMB assets in their components, resulting in asset managers increasing their allocation to RMB-denominated assets. We are closely monitoring the progress of RMB internationalisation and its implications for investors.”

Further reforms to drive bond market expansion

China’s bond market has grown rapidly over the past decade and we do not expect the pace to slacken in the near future. Indeed, we believe that the SDR push and further currency liberalisation measures will continue to drive bond market expansion for the foreseeable future.

In order to maximise returns, we consider it essential to adopt an active investment strategy, seeking to make the most of returns across currency, rates and credit. We are particularly constructive on onshore RMB corporate credit. Indeed, international investors are increasingly able to access China’s onshore bond market to avail themselves of potentially attractive returns on offer.

We believe that the key to deriving attractive returns in China’s onshore corporate bond market is to undertake bottom-up, fundamental analysis of a company’s standalone business and financial risk while also evaluating its relationship to China’s evolving policy landscape. We feel that this is the only reliable way to determine the true risk-return proposition of any potential onshore RMB bond investment – and it is the foundation of our fixed income investment process.