UOB Global Economics and Markets Research
Company Reg No. 193500026Z

Suan Teck Kin Suan.TeckKin@UOBgroup.com

Flash Notes

Thursday, 30 April 2015

China: Aiming for the SDR Basket

- With its rising economic size and position as a top trading nation, China is aiming for the RMB to be included into the SDR basket of currencies at the 2015 IMF review, which could further accelerate the RMB internationalization efforts and adoption.
- However, a positive decision remains uncertain at this year's review, as it can be argued that China has yet to satisfy all the four requirements set out by IMF in 2011, and we estimate the probability of RMB's admission into SDR in 2015 at 60%.
- As China keeps its eyes on the SDR basket, the risks of a sharp depreciation for the RMB would be low, and our projections for USD/RMB exchange rate still stand at 6.22 for end-2Q15, and 6.20 for end-2015, vs. current 6.20 level. We also expect a further widening of the RMB trading band to 3% from 2% sometime this year.

Summary: China Seeking to Score the SDR basket

Among the key initiatives for China this year is to have the RMB admitted into International Monetary Fund (IMF) Special Drawing Rights (SDR) basket of currencies, which currently consists of four currencies: US dollar, the euro, British pound, and Japanese yen. SDR is a reserve asset created by IMF in 1969 to supplement its members' international reserves. The SDR is reviewed every five years ("quinquennial"), and a decision is due by end of 2015 for the latest review.

As China presses ahead with capital account opening and RMB internationalization, an endorsement from the IMF and international community via admission into the SDR basket would accelerate this process further, and widen the acceptance of RMB in the global financial system. From China's point of view, a positive decision from IMF would affirm its efforts of more than 2 decades to integrate with the global financial system and allow China a greater say in international financial affairs.

To be sure, China's rising stature in the global economy and as a top trading nation means that its currency should be a candidate as a reserve currency. On its part, China has also gradually liberalized its capital account for fund inflows and outflows and strengthened the resilience of its domestic financial markets, though much more work needs to be done.

Will China be able to score the SDR basket this year? A positive decision remains uncertain, as it can be argued that China has yet to satisfy all the four requirements set out by IMF in 2011, especially the condition that the currency to be widely held as a reserve currency. **We estimate the probability of the RMB's inclusion into SDR in 2015 at 60%,** with the remaining 40% hinging on factors such as evaluation by IMF executive board, which is dominated by advanced economies and has yet to implement the quota reform agreed to in 2010.

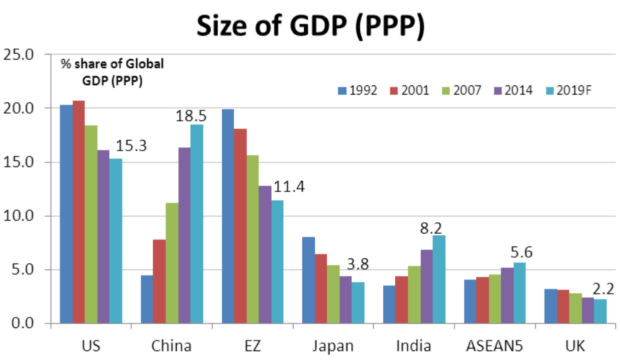
As China keeps its eyes on the SDR, the risks of a sharp depreciation for the RMB are relatively low as it would jeopardize the chance of becoming a reserve currency. Concerns for depreciation were heightened in early 2015 when the RMB fell to nearly 3 year low of 6.274/USD. Furthermore, there are no fundamental reasons to support a sharp depreciation or devaluation of the currency, given the size of its foreign reserves at USD3.7tn. **We continue to expect USD/RMB exchange rate at 6.22 for end-2Q15, and 6.20 for end-2015, vs. current 6.20 level.** However, the RMB is likely to move in volatile fashion on a day to day basis as it responds to both domestic and global market conditions, and we are still expecting a further widening of the RMB trading band to 3% from 2% sometime this year.

How Has China Progressed So Far?

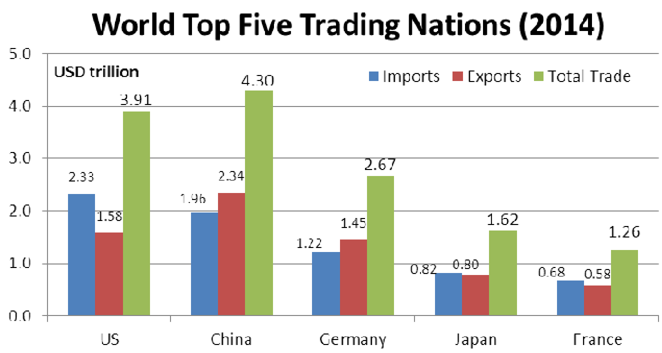
China's rise as a major economy and trading nation has been progressing at an astonishing speed over the past three decades. Based on IMF's purchasing power parity (PPP) measure, China's economic size rose from less than 5% share of the global economy in early 1990s, to 16.3% share in 2014, and is projected to account for nearly 20% of the global economy by 2020. Meanwhile, the size of the US economy is expected to decline steadily from nearly 20% in early 1990s and 2000s, to 15% share by 2020. As shown in the chart, it is remarkable that both China and India started at about the same size, though India's economy has expanded much slower and is projected to be less than half of China by 2020.

As a trading nation, China's combined value of exports and imports is the largest in the world at US$4.3tn in 2014, given its position as the world's largest exporter. However, in terms of imports, China trails the US, but still imported about the same amount in 2014 as the next two large importers, Germany and Japan, combined.

At the same time, this economic strength and trading strength have also spilled into the financial arena, with the most visible impact being the internationalization of the RMB, as well as the opening of the capital account in recent years as China stepped up financial connections with the rest of the world.



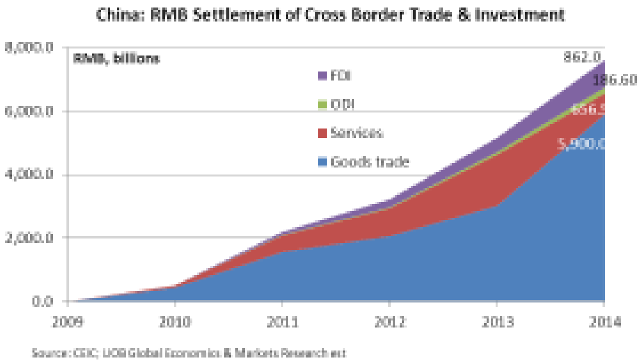
Source: IMF data via Bloomberg; UOB Global Economics & Markets Research est

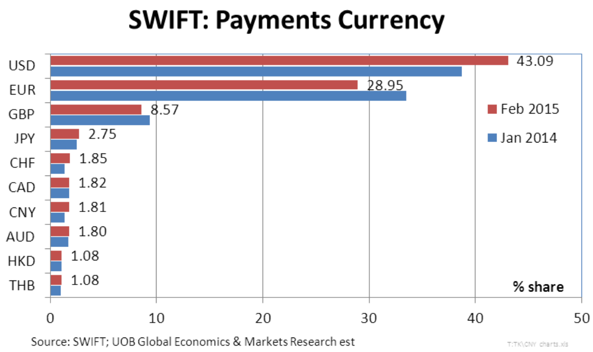


Source: UNTACD; UOB Global Economics & Markets Research est

The use of RMB as a payments and trade settlement currency has also increased significantly. For instance, the amount of cross border goods and services trade settled in RMB has risen from virtually zero prior to 2009, to RMB6.5tn in 2014, or about 25% of China's total trade. Similarly for foreign direct investment and outward direct investment, the amount settled in RMB has also picked up sharply, (see chart below).

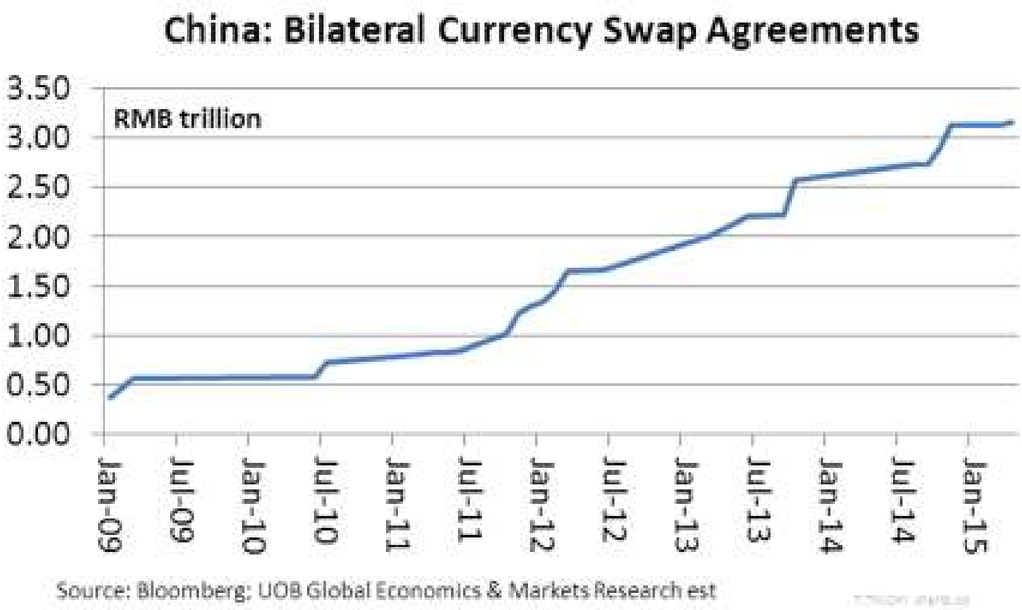
Based on SWIFT (Society for Worldwide Interbank Financial Telecommunication) payments data, RMB is now the world's 7th largest currency in terms as a payments currency, with 1.8% share. While this value looks small or insignificant, the difference with Japanese yen at number 4 is only 1% point. With the ongoing internationalization and widening adoption, the RMB could soon catch up with the Japanese yen or even the British pound. However, it will take a long time for China to challenge the position of the euro or even the US dollar, the top two payments currencies in the world.





The setting up of RMB clearing arrangements will play an important role in facilitating cross-border payments, as well as closer integration and relations with these economies, and will benefit corporates and financial markets along the way. China has so far established offshore RMB centers in 14 countries/regions, covering trading time zones from East Asia to North American west coast when Vancouver joined the rank with Toronto in March 2015. In addition, China has signed bilateral currency swaps agreements with foreign central banks to the tune of RMB3.15tn as of April 2015, from just RMB180bn when the process started in late 2008.

More important however, is for the Chinese government to strengthen the domestic financial sector, in particular banks, so that it is sufficiently resilient to cope with the new pressures that financial liberalisation inevitably brings. The integration of a new major currency in the global financial system means that domestic shocks would transmit more easily across borders. On this front, it should be noted that the Chinese authorities are embarking on the implementation of banks' deposit insurance scheme (effective 1 May 2015), and restructuring of local government debt, among other things, to improve resilience of the domestic financial system.



What is IMF's Special Drawing Rights (SDR)?

The SDR (which is also known as "paper gold") is an international reserve asset, created by the IMF in 1969 to supplement its member countries' official reserves. Its value is based on a basket of four key international currencies (as of April 2015), and SDRs can be exchanged for freely usable currencies. As of 17 March 2015, 204bn SDRs were created and allocated to members (equivalent to about US$280bn).

The SDR is neither a currency, nor a claim on the IMF. Rather, it is a potential claim on the freely usable currencies of IMF members. Holders of SDRs can obtain these currencies in exchange for their SDRs in two ways: first, through the arrangement of voluntary exchanges between members; and second, by the IMF designating members with strong external positions to purchase SDRs from members with weak external positions. In addition to its role as a supplementary reserve asset, the SDR serves as the unit of account of the IMF and some other international organizations. As such it should be clear that the SDR by itself does not function as "money", as it is only able to fulfill the role of "unit of account" and "store of value", and not the role "medium of exchange" for payments for goods and services and repayment of debts.

The SDR basket today consists of the euro, Japanese yen, pound sterling, and US dollar. The value of the SDR in terms of the US dollar is determined daily, calculated as the sum of specific amounts of the four basket currencies valued in US dollars, on the basis of exchange rates quoted at noon each day in the London market. The weights of these currencies are shown in the table. Valuation of SDR is posted on IMF website (https://www.imf.org/external/np/fin/data/rms_sdrv.aspx).

The basket composition of SDR is reviewed every five years ("quinquennial"), or earlier if the IMF finds changed circumstances warrant, to ensure that it reflects the relative importance of currencies in the world's trading and financial systems. This happened in 1998 when the euro was incorporated into the SDR basket, replacing Deutsche mark and French franc.

SDR Basket Weightage (% share)

	IMF/WB Annual Meetings	Decision announced	USD	EUR	GBP	JPY	Sum
2011-2015	8-10 Oct 2010	15 Nov 2010	41.9%	37.4%	11.3%	9.4%	100.0%
2006-2010	24–25 Sep 2005	28 Oct 2005	44.0%	34.0%	11.0%	11.0%	100.0%
2001-2005	19–28 Sep 2000	12 Oct 2000	45.0%	29.0%	11.0%	15.0%	100.0%
1999-2000*	29 Sep – 8 Oct 1998	31 Dec 1998	39.0%	32.0%	11.0%	18.0%	100.0%

*Euro was introduced in the SDR basket from 1999, with the weight consisting of DEM (21%) and FFR (11%) upon inception.

Source: IMF; UOB Global Economics & Markets Research est

In 2011, the IMF Executive Board set down the criteria that a country should meet in order for its currency to be included in the SDR basket. First, the currency should be actively traded on foreign exchange markets. Second, there should be active markets in exchange-based and over-the-counter foreign exchange derivatives. Third, the country should have market-based interest rate instruments. And, fourth, the currency should be widely held as foreign exchange reserves. (Please refer to : "IMF Executive Board Discusses Criteria for Broadening the SDR Currency Basket,", IMF Public Information Notice (PIN) No. 11/137, 11 November 2011, https://www.imf.org/external/np/sec/pn/2011/pn11137.htm)

China is likely to be able to meet the first three criteria of active trading and availability of FX derivatives given the ongoing RMB internationalization efforts, while the onshore interest rate market will be liberalized before end of 2015 following the implementation of deposit insurance system on 1 May 2015. The last criterion on foreign exchange reserves will be problematic, as it is really a chicken-and-egg problem: the currency needs to be widely held as a foreign reserves asset to be included in SDR, however foreign central banks would only increase holding of that currency if it is in the SDR basket. As such, it could be a contentious issue leading up to the decision at the end of this year.

For the 2015 edition, Annual Meetings of the World Bank Group and the International Monetary Fund are slated to take place in Lima, Peru, from 9 to 11 Oct 2015. As shown in the table, a decision is likely to be returned approximately one month after the end of the Annual Meetings, though it could be as late as the end of the year in certain circumstances, as in the case for the euro's inclusion into SDR basketin 1999.

China's March towards Capital Account Convertibility

China began its pursuit of capital account convertibility more than 2 decades ago, when the Third Plenum of 14th CPC Central Committee in 1993 set the goal of "gradually making the RMB a convertible currency."

After achieving current account convertibility in 1996, China set its target on capital account convertibility. The quest was twice interrupted: first by the 1997 Asian Financial Crisis, and then the 2008/09 Global Financial Crisis.

Nevertheless, the progress has largely remained on track with gradual liberalization, with the RMB becoming convertible for foreign direct investment (FDI) and outward direct investment (ODI); registration-based management has been adopted for trade credit and trade-related claims on nonresidents, and only external debt remains subject to quota management; Qualified Foreign Institutional Investors (QFII) and Qualified Domestic Institutional Investors (QDII) programs have been introduced and improved. In addition, China also expanded the usage of RMB in cross border trade and investment, establishing offshore RMB centers in 14 countries/regions, as well as the signing of bilateral currency swaps with foreign central banks, establishing free trade zones (Shanghai Pilot Free Trade Zone was established in 2013) cross-border stock connect (Shanghai-HK Stock Connect scheme commenced in late 2014), among others.

Obviously, the aim is to achieve some form of full capital account convertibility and PBoC noted that currently more than 85% of China's capital account (35 out of 40 items) are either fully or partly convertible under IMF classification. The remaining 15% (5 out of 40 items) that are still nonconvertible include individual cross-border investment and the issuance of shares and other financial instruments by nonresidents on domestic markets. In PBoC's view, it is getting close to full capital account convertibility.

The five broad items that are currently nonconvertible will be gradually liberalized in 2015, making the RMB a more freely usable currency, according to China's plans.

The steps to be taken include:

1) For individuals: channels for cross-border investments include the pilot Qualified Domestic Individual Investor (QDII2) program;
2) For the upcoming Shenzhen-Hong Kong Stock Connect program, nonresidents will be allowed to issue financial products on the domestic markets with the exception of derivatives;
3) Foreign exchange regulations will be revised to remove requirements for ex ante approvals in most cases, and a system for ex post monitoring;
4) For foreign institutional investors, further access to the Chinese capital markets;
5) Further facilitate the international use of the RMB by removing unnecessary policy barriers and providing the necessary infrastructure.

Implications of Inclusion into SDR

RMB's admission into the SDR basket will be a significant step forward for the internationalization efforts, and likely to boost further usage and acceptance as a currency for international trade and investment. It will also allow the RMB to be a contender as a reserve currency, in addition to the US dollar, euro, British pound, and Japanese yen, given that SDR itself is counted as part of a country's foreign exchange reserves.

Beside being counted as a reserve currency, this will allow the RMB to contest in the space of pricing commodities with China being a large consumer. In addition, the more widely used and internationalized RMB is, the easier and less costly for China-based businesses to venture abroad through trade or investment.

In terms of weightage in the SDR basket, it is worth noting from the table earlier that GBP's share has stayed quite constant throughout the period while JPY's share has fallen steadily, consistent with Japan's waning economic influence. As such, it is very likely that inclusion of RMB would be at the expense of JPY and GBP, and to a lesser extent from EUR and USD, depending on what is the entry weight for the new constituent. A 10% to 15% weight for the RMB at the outset would be a good starting point for the new SDR basket.

What are the chances for RMB's scoring the SDR basket in 2015? At this stage, it remains uncertain as it can be argued that China has yet to satisfy all the requirements set by IMF in 2011, especially the part on foreign central banks and governments holding a significant share of their foreign exchange reserves in the RMB. On this criterion, it is really a chicken-and-egg problem, i.e. the currency needs to be widely held as a foreign reserves asset to be included in SDR, however foreign central banks would be more inclined to increase holding of that currency if it is in the SDR basket.

We estimate the probability of the RMB's inclusion into SDR in 2015 at 60%, with the remaining 40% hinging on factors such as evaluation by IMF executive board, which is dominated by advanced economies and has yet to implement the quota reform agreed to in 2010.

For the RMB exchange rate itself, the risks of a sharp depreciation or devaluation have certainly diminished significantly as China aims for the SDR basket. A sharp weakening of the currency would certainly jeopardize the chance of becoming a reserve currency. Furthermore, there are no fundamental reasons to support such weakening, given the size of its foreign reserves at USD3.7tn. **We continue to expect USD/RMB exchange rate at 6.22 for end-2Q15, and at 6.20 for end-2015, vs. current 6.20 level.** However, the RMB is likely to move in volatile fashion on a day to day basis as it responds to both domestic and global market conditions, and we are still expecting a further widening of the RMB trading band to 3% from 2% sometime this year.