UOB

Suan Teck Kin, CFA
Suan.TeckKin@uobgroup.com

Global Economics & Markets Research
Email: GlobalEcoMktResearch@uobgroup.com
URL: www.uob.com.sg/research

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Flash Notes

China: Edging Closer To SDR Decision

- IMF signaled further progress in China's entry into the SDR basket of currencies, with a decision expected on 30 Nov and the chances of a positive outcome are likely to have gone beyond our assessment of 80% probability

- A favourable result would be an endorsement of China's efforts in market reforms and opening up, similar to the country's accession into WTO in 2001 and its subsequent rise as an economic power

- While a positive decision will be supportive for the RMB in the mid-to-long term horizon, near term upside may be short lived and dampened due to the possible delayed implementation of the new basket. We are keeping our RMB forecasts of end-2015 USD/CNY of 6.40 and end-2016 projection of 6.45, and looking out for the possibility of a band widening

Encouraging Signals From IMF
The potential inclusion of China's RMB into IMF's Special Drawing Right (SDR) basket of currencies received a strong boost over the weekend with signals from IMF's Managing Director Christine Lagarde.

In the statement dated 13 Nov 2015, Lagarde gave her support for IMF staff's findings that "… RMB meets the requirements to be a "freely usable" currency and, accordingly, the staff proposes that the Executive Board determine the RMB to be freely usable and include it in the SDR basket as a fifth currency, along with the British pound, euro, Japanese yen, and the U.S. dollar. The staff also finds that the Chinese authorities have addressed all remaining operational issues identified in an initial staff analysis submitted to the Executive Board in July."

This explicit support for RMB's inclusion into the SDR is indeed a positive signal, of which China's PBoC responded in a statement dated 14 Nov 2015, reiterating its determination for financial sector reforms and opening, and that the inclusion into SDR would enhance SDR's attractiveness and representation.

Increasing Chances For RMB In SDR Inclusion
As China continues to meet the "export" criterion of the SDR, the main issue is whether the RMB meets the "freely usable" condition (i.e. widely used to make payments for international transactions and widely traded in the principal exchange markets). IMF's Executive Board is scheduled to meet on 30 Nov 2015, to consider the issue and decide whether the RMB should be included in the SDR basket.

IMF noted that capital account convertibility is not a necessary condition to determine whether a currency is widely used and widely traded, as a fully convertible currency may not necessarily be widely used and widely traded.

Should the Executive Board decide to include the RMB in the SDR basket, the new basket of currencies would take effect on 1 Oct 2016. IMF said the reasons for the delay in the new SDR basket implementation are to:

1. avoid changes in the basket at the end of the calendar year (when trading volumes are low);
2. facilitate the continued smooth functioning of SDR-related operations amidst a higher than-usual level of uncertainty generated by the ongoing SDR review; and
3. allow sufficient lead time to adjust in the event that a decision were to be taken to add a new currency to the SDR basket.

What's Next For RMB?
In its journey towards RMB's inclusion into the SDR, China has undertaken more than two decades of financial market reforms and capital account convertibility, when the Third Plenum of 14th CPC Central Committee in 1993 set the goal of "gradually making the RMB a convertible currency". This set off the unification of the dual exchange rates beginning 1 Jan 1994, when the official rate of 5.8 to the US dollar was devalued by 36% to the end-1993 swap-market rate of 8.7/USD, and abolishing the Foreign Exchange Certificates.

These early reforms laid the foundation for subsequent financial market developments in China which included the exchange rate reform in Jul 2005, the acceleration of the RMB internationalization in 2009, gradual opening of capital account via various schemes such as QFII/QDII, the reform of RMB central parity fixing mechanism on 11 Aug 2015, among others. According to the PBoC, 85% of China's capital account is already convertible to a certain extent.

A favourable outcome on the SDR from IMF will undoubtedly be seen as an endorsement for China's efforts in the road of market reforms and opening. In fact, reforms in various domestic markets could be accelerated with the opening up of the financial sector via SDR. This should be seen along the line of to China's accession into the World Trade Organization (WTO) in Dec 2001 and its impact on the country's manufacturing sector and the country's rise as an economic power. On its own, China has set the target of full convertibility of capital account and the RMB during its 13th 5-year plan period of 2016-2020.

With IMF's latest announcement, the chances of RMB gaining inclusion into SDR have surely risen beyond our earlier assessment of 80% of probability of success. However, there is still some degree of uncertainty given that the US holds the largest voting block of 16.74%, followed by Japan's 6.23% and Germany's 5.81%. China's vote share is 3.81%.

As a change in the SDR basket requires 70% of the vote in IMF Executive Board, the US wields significant influence in this case. In any case, recent remarks by various US officials and the softer tone on the RMB in the latest US Treasury's "Semiannual Report on International Economic and Exchange Rate Policies" (released on 19 Oct 2015) suggest an uncontroversial outcome when IMF Executive Board meets on 30 Nov.

While a positive decision will be supportive for the RMB in the mid-to-long term horizon, in the near term upside for the RMB may be only short lived and dampened given that:

1. implementation of the new SDR basket likely to be delayed until 1 Oct 2016;
2. massive and deadly terrorist attacks in Paris over the weekend could spark off a new round of risk aversion in global financial markets that would be supportive of USD assets;
3. initial take up in FX reserves for RMB and RMB-denominated assets is likely to be gradual and measured, due to conservative nature of central banks' reserve management and the general lack of safe RMB-denominated assets; and
4. market attention will be shifted towards US Fed's interest rate hike as the FOMC meeting looms in Dec 2015.

PBoC earlier estimated that as at end-Apr 2015, global central banks held about RMB666.7bn of RMB-denominated bonds, shares, and deposits both onshore and offshore. This is equivalent to US$107.5bn and a tiny faction of global reserves of US$11.5tn. As such, it may be sometime for the RMB to rise to any significant proportion even if the currency is included into the SDR this year.

On the other hand, we do not see much convincing evidence that points to the direction of large scale or prolonged RMB depreciation, whether it is from the angle of underlying domestic economic data, political stability, financial market developments, or debt or capital flows dynamics.

As such, we are keeping our RMB forecasts for now, with end-2015 USD/CNY at 6.40 and end-2016 projection of 6.45. Further market reform measures in China are expected to continue into 2016, and the **possibility of a band widening is still likely**, to 3% or even more, from 2% currently. As for the onshore-offshore RMB spread, we think that any significant deviation from the 50-200 point spread is likely to attract attention from the authorities, which did not hesitate to intervene in the past few months when price gaps deviated too far.

More importantly, these developments in market reforms and opening, together with uncertainty in the global markets and the end of one-way appreciation trend for the RMB, would result in further two-way moves and flexibility of the RMB exchange rate. This means that risk management/control and hedging are now an increasingly critical part of business operations.

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