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Flash Notes

China: To The SDR And Beyond

- As widely expected, IMF Executive Board approved China's RMB inclusion into the SDR basket of currencies at its decision on 30 Nov, with a weight of 10.92%, effective from 1 Oct 2016.
- IMF also implements a new weighting formula for the SDR, which means that China is likely to stay on its market reform track to improve its weightage, as it eyes capital account and currency convertibility by 2020.
- Notwithstanding the positive development, we maintain our outlook for USD/CNY, with end-2015 forecast at 6.40 and end-2016 projection of 6.45 and still see a low probability of large scale or sharp depreciation of the currency ahead of the new basket implementation in Oct 2016.

IMF Approves RMB Inclusion Into SDR
As widely anticipated, at the 5-yearly review on 30 Nov (1 Dec in Asia) IMF's Executive Board endorsed China's RMB inclusion into the Special Drawing Rights (SDR) basket of currencies as the fifth component, with effect from 1 Oct 2016. The other four currencies are the US dollar, the euro, British pound, and Japanese yen.

IMF acknowledged that as there are no pre-set thresholds or benchmarks, the decision was a policy judgment by the Executive Board, which determined that the RMB had met the freely usable criterion, "framed by the definition of freely usable under the IMF's Articles of Agreement and informed by quantitative indicators." The next SDR review will be by 30 Sep 2021, unless an earlier review is warranted by developments in the interim.

The inclusion of the RMB is the first major change to the SDR basket composition since 1980 when the basket size was reduced from 16 to 5 currencies (which was later reduced to the current four in 1999, when the euro replaced the Deutsche mark and the French franc).

The weightage of the RMB will be 10.92% to start, with US dollar retaining much of its original weight at 41.73%, while EUR would come in at 30.93%, down from 37.4% previously, as shown in the table. At this point, one should not be overly concerned what the starting weight is for RMB, as it is subject to review every 5 years.

SDR Basket Weightage (% share)								
	IMF/WB Annual Meetings	Decision announced	USD	EUR	GBP	JPY	RMB	Sum
2016-2021*	*9-11 Oct 2015*	*30 Nov 2015*	*41.73%*	*30.93%*	*8.09%*	*8.33%*	*10.92%*	100.0%
2011-2015	8-10 Oct 2010	15 Nov 2010	41.9%	37.4%	11.3%	9.4%	0.0%	100.0%
2006-2010	24–25 Sep 2005	28 Oct 2005	44.0%	34.0%	11.0%	11.0%	0.0%	100.0%
2001-2005	19–28 Sep 2000	12 Oct 2000	45.0%	29.0%	11.0%	15.0%	0.0%	100.0%
1999-2000**	29 Sep – 8 Oct 1998	31 Dec 1998	39.0%	32.0%	11.0%	18.0%	0.0%	100.0%

Source: *SDR weights effective from 1 Oct 2016; Next IMF review on SDR by 30 Sep 2021
** The euro was introduced in the SDR basket from 1999 onwards, with the weight consisting of DEM (21%) and FFR (11%) at inception.
Source: IMF; UOB Global Economics & Markets Research

The new SDR basket will take effect from 1 Oct 2016 (as opposed to taking effect on 1 Jan as is usually the case), is to:

1. avoid changes in the basket at the end of the calendar year (when trading volumes/liquidity are typically low and could cause exaggerated price moves);

2. facilitate the continued smooth functioning of existing SDR basket; and
3. allow sufficient lead time for portfolio adjustments.

A Further Boost To RMB Internationalization
The SDR decision will certainly have both symbolic and substantial implications for the RMB and global financial systems.

Symbolically, the inclusion of RMB will be seen as IMF's endorsement of China's efforts in opening and reforming of its financial system, signaling that the RMB is having similar status as other reserve currencies such as the US dollar and the euro. Indeed, China has vowed to continue on these efforts, by making its capital account and the RMB convertible during the 13th 5-year plan in 2016-2020.

On the other hand, IMF's own standing globally would be strengthened by formally acknowledging the rise of China's economic influence and the increasingly important role of RMB in the global financial markets.

Pragmatically, the SDR decision will help to further the internationalization of RMB and have a positive effect on the exchange rate, as the RMB's status is now elevated to that of "reserve currency". This means that central banks and other asset managers would need to adjust their portfolio allocation to accommodate RMB-denominated assets. However, as asset allocations would take time given the dearth of quality RMB assets, these positive effects on the RMB are likely to dissipate quickly and give way to more immediate concerns of the upcoming US nonfarm payroll report and US Fed's FOMC in mid-Dec, which should keep the USD supported.

In addition to the RMB's inclusion, a new weighting formula for the SDR currencies was also adopted at the 2015 review. It is based on:
1. the value of exports;
2. the amount of reserves denominated in the respective currencies that were held by other members of the IMF;
3. foreign exchange turnover; and
4. international bank liabilities and international debt securities denominated in the respective currencies.

While there is no concern of the exports aspect, China is likely to continue to stay on track or even doubling its efforts for financial market reform and capital account liberalization in order to improve its performance in the financial indicators, before the next review by Sep 2021.

We reiterate our view that the RMB is unlikely to see sharp or prolonged depreciation, as measures taken since the 11 Aug central parity change showed that Chinese authorities were not keen to pursue such a strategy and moreover, there will be a long lead time before the new SDR basket is implemented.

The Beginning Of RMB's Reserve Status
Beyond the short term effect on the exchange rate and price volatility, the more important trend to watch is how the RMB would alter the landscape over the medium to long term. One question is how long would the RMB take to match up to the USD as a major currency?

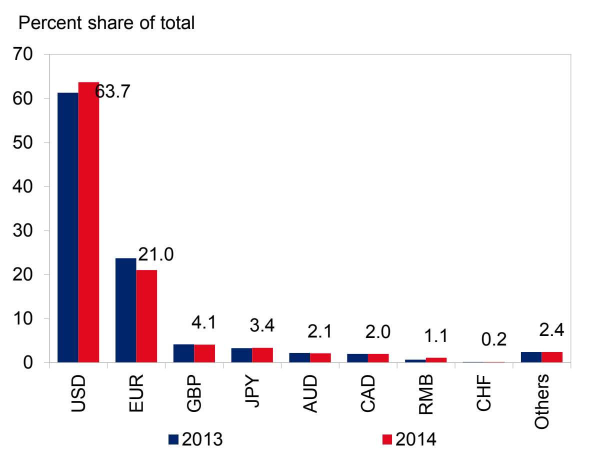
Looking at some of the metrics, the RMB has some way to go. However, with increased trade and investment flows between China and the rest of the world, and especially with China's own "One Belt One Road" initiative, and based on experiences of reserve currencies such as the US dollar and euro, we expect the RMB to gradually become a more widely used and traded currency over the next 5-10 years, and there is certainly room for expansion.

As at end-2014, estimates from IMF show that RMB's share was only about 1.1% of total global reserves of US$11.8tn, compared to US dollar's 64% share. Considering that RMB's internationalization process started in 2010, and is expected to achieve capital and currency convertibility by 2020, it is conceivable that RMB to at least catch up to the sterling's 4% share by then, or an additional US$350bn being allocated to the RMB.

The minuscule allocation to RMB is reflected in the low issuance of RMB debt securities that accounted for just 1.4% in the international market in 2014, compared to 12% share for sterling-denominated debt.

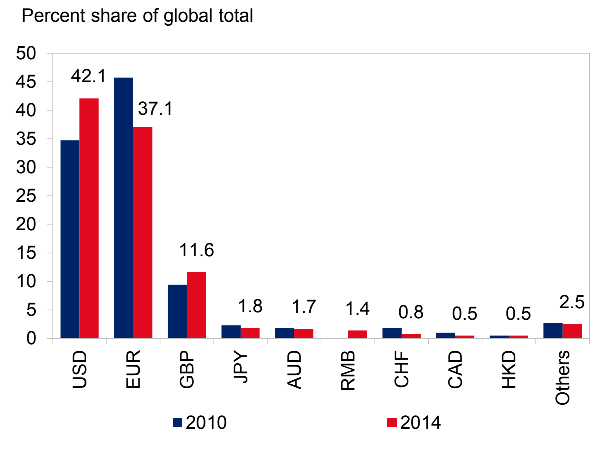
In terms of the onshore bond market in China, there is significant room for growth as non-residents' holdings of onshore bonds amounted to just about 2.5% share, or RMB735bn, of the total market, which is insignificant even compared to emerging markets. For instance, bond

Allocation of Global Official Foreign Reserve Currency Assets



Source: IMF, UOB Global Economics & Markets Research markets in ASEAN see foreign holdings accounting for as much as 40% of domestic government bonds. With China's central government debt issuance at just around RMB1.4-1.8tn per year since 2009, that would require a sharp increase in issuance to meet demand from central banks and other institutions.

Issuance of International Debt Securities



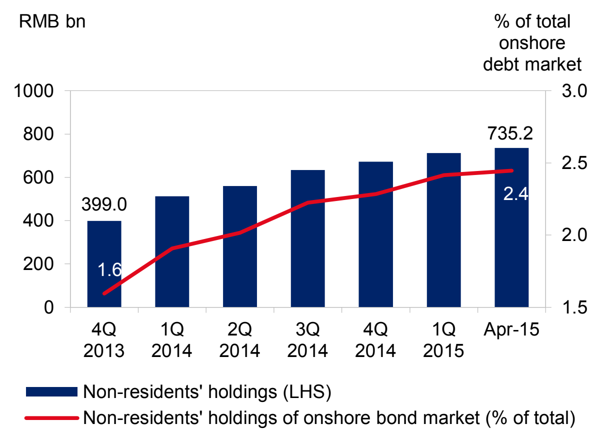
Source: IMF, UOB Global Economics & Markets Research

Beyond SDR: What's Next For China And The 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.

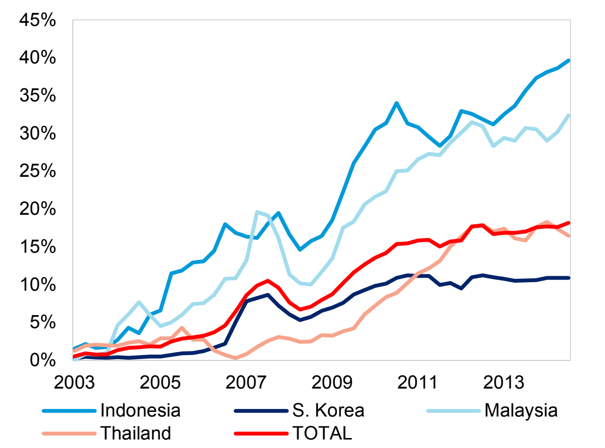
This favourable outcome from IMF should encourage greater and faster reforms in various domestic markets with the further opening up of the financial sector via SDR. This in turn would encourage wider adoption of the RMB in global markets. This should be seen along the line of China's accession into 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.

China: Non-residents' Holdings of Onshore Debt Securities



Source: CEIC, PBoC, UOB Global Economics & Markets Research

Ratio of Foreign Holdings of Govt Bonds (USD)



Source: Bloomberg, CEIC, UOB Global Economics & Markets Research

Near term upside for the RMB may only be short lived and dampened given that:

1. implementation of the new SDR basket to be delayed until 1 Oct 2016;
2. 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/quality RMB-denominated assets; and
3. market's attention will be shifted towards US Fed's interest rate hike as the FOMC meeting looms in Dec 2015.

However, we do not see much convincing evidence that points to the direction of large scale or prolonged RMB depreciation over the next 1-2 years, whether it is from the angle of underlying domestic economic data, political stability, financial market developments, or debt or capital flows dynamics. Politically and from IMF's standpoint, it is difficult for China to get back to the one way appreciation (or depreciation) trend as it did in the past.

With the implementation of the SDR basket extending to Oct 2016 and also the 5-year review cycle of the SDR, it is unlikely that China would pursue a weak currency or "currency war" to boost exports or domestic growth, knowing full well the futility of such strategy. Measures taken by the central bank since the 11 Aug central parity reform suggests that it is in fact concerned about excessive expectations of RMB depreciation.

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 beyond, and the **possibility of a band widening is still likely**, to 3% or even more, from 2% currently.

But more importantly, the ongoing reforms, 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, would mean risk management/control and hedging an increasingly important part of business operations.

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