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China's RMB: winning the SDR battle

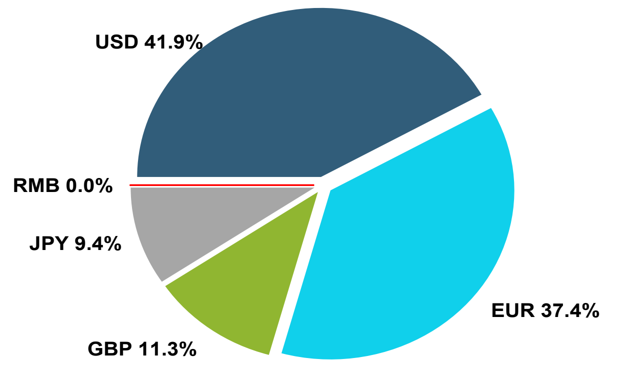
SDR inclusion is a milestone for China's capital account convertibility and RMB globalisation

Key points

- China is making an active bid for the RMB's inclusion in the IMF's SDR basket at the Fund's five-year review in late 2015.
- After examining the two-part decision process, we think the RMB still faces some hurdles for being a freely usable currency, constrained by the remaining capital account controls.
- However, given the subjective nature of the technical assessment, we think there is enough scope for China to make a favourable case for the RMB, following the recent reforms on capital account convertibility.
- The strong political and diplomatic momentum – think of the AIIB and OBOR initiatives – would also serve to China's advantage in boosting the RMB's chance at the IMF's board voting.
- **With these, we see a greater-than-even chance for the RMB to be included in the SDR this year.** But even if it misses the cut, there is a high likelihood of an inter-meeting review that will grant RMB the SDR status before the next scheduled decision in 2020.
- We think the immediate impact of the SDR inclusion will be limited for China's financial markets. But the subsequent spill over effect could be large, as reserve managers and institutional investors alter their global investment allocation. A more liberalised external account would also benefit China for reforming its financial system and rebalancing the economy.

IMF Special Drawing Rights: four currencies today…

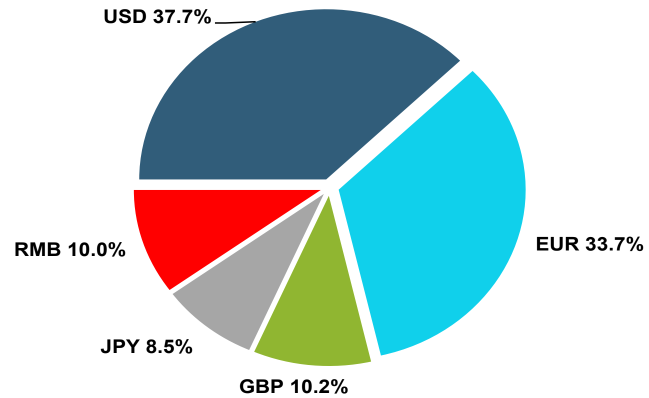
Current SDR basket



Source: IMF and AXA IM Research

… Five currencies tomorrow, if China join in?

Hypothetical SDR with RMB



Source: IMF and AXA IM Research

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Capital account liberalisation to win RMB's inclusion in the SDR

One of the most anticipated events for China this year is the quinquennial review of the IMF's Special Drawing Right (SDR), for which **China is trying to bring its currency, the RMB, into the basket.** The SDR is an international reserve asset created by the IMF in 1969, and it currently consists of assets in four currencies: the USD, EUR, GBP and JPY.[1]

China's attempt to bring the RMB into the SDR failed at the last IMF Review in 2010 because of insufficient capital account convertibility. Since then, the Chinese government has made substantial progress in opening up the capital account and liberalising the exchange rate, with the pace of liberalisation accelerating in the last two years (*Exhibit 1*). The People's Bank of China (PBoC) governor, Zhou Xiaochuan, pledged to **"make the renminbi capital account convertible" by the "end of this year"**, signalling a strong commitment to win RMB's bid into the SDR this year.[2]

The SDR Review occurs every five years, with the next one due to take place later this year. The review consists of two parts: 1) **a technical assessment**, which determines whether the RMB meets the SDR criteria and 2) **a final vote by the IMF Board**. The technical assessment will likely take place at the informal board meeting in June, while the final decision and official announcement will be made later in the year, most likely in October.

[1] According to the IMF, the SDR is neither a currency nor a claim on the IMF. Instead, it is a potential claim on the freely usable currencies of IMF members that holders can obtain in two ways: 1) through voluntary exchanges between IMF members, and 2) through the IMF, designating members with strong external positions to purchase SDRs from members with weak external positions.

[2] Zhou, X., Statement at 31st meeting of the IMF's International Monetary and Financial Committee meeting, 18-April-2015.

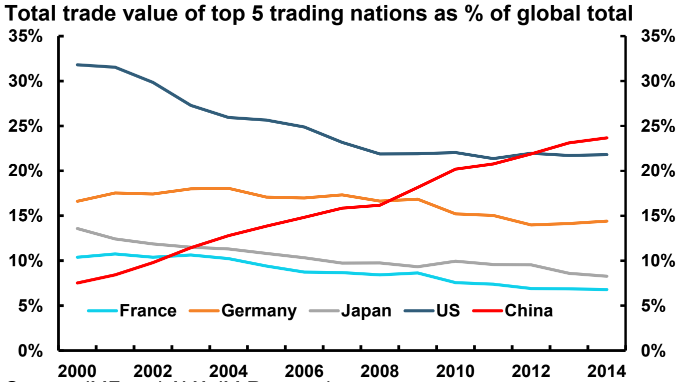
How RMB stacks up on the technical criteria

The first hurdle facing the RMB to become an SDR currency is the technical review, which comprises two components: 1) a so-called **quantitative gateway criterion**, which requires the country, to which the currency belongs, to be a major trading nation; and 2) a qualitative assessment on how **freely usable** the currency is.

Exhibit 2

China has risen as the undisputable champion in global trade

Total trade value of top 5 trading nations as % of global total

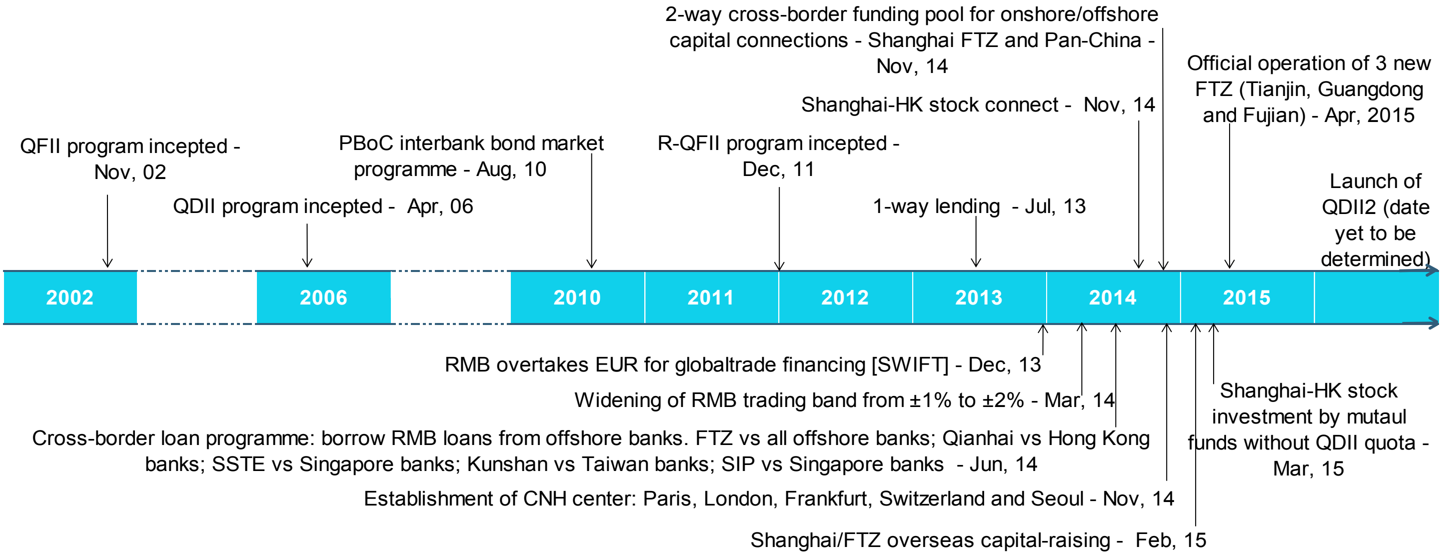


Source: IMF and AXA IM Research

On the gateway criterion, China passes the test with flying colours for being the undisputable champion in global trade. China surpassed Germany as the world's largest exporter in 2009, and has since strengthened its dominant position. On the import side, China is the world's second largest importer, only marginally behind the US, accounting for 11% of import values. In 2014, China's total trade values (exports plus imports) amounted to US$4.3tn, accounting for 24% of global trade (*Exhibit 2*). On this matrix, the RMB clearly earns its right to be part of the SDR basket.

Exhibit 1

Pace of capital account liberalisation and exchange rate reform has accelerated significantly



Source: various media sources and AXA IM Research

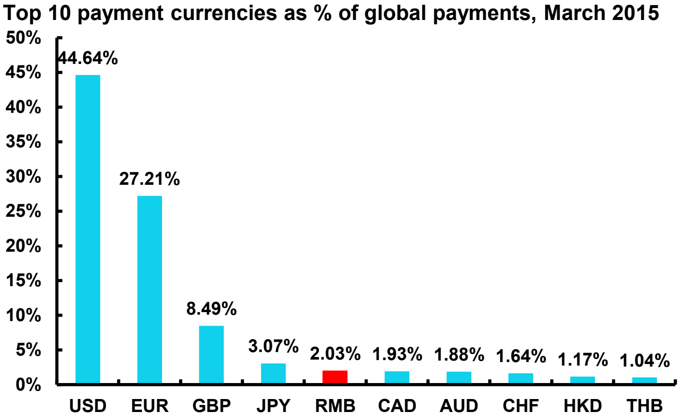
It is, however, more debatable whether the RMB satisfies the freely usable criterion. Even though China has achieved full convertibility in the current account as early as 1996, significant capital account restrictions remain in place. The lack of sufficient capital account convertibility was what stopped the RMB's inclusion in the SDR at the last review, and will likely remain a contentious issue this time around.

To be clear, **the IMF does not**, or at least not explicitly, **require full convertibility in a currency for it to be deemed freely usable**. The JPY, for example, was determined as freely usable in 1978, two years before Japan abolished all its foreign exchange controls.[3] For China, the government has never committed to full capital account liberalisation. Instead, **it aims to achieve a form of managed convertibility, where the authorities retain some options to intervene in the market by using macroprudential measures on special occasions.**[4] A certain degree of capital account management, which is now endorsed by the IMF, should not affect the RMB's chance to become a SDR currency, in our view.

Exhibit 3

RMB is the fifth mostly used currency in global payments

Top 10 payment currencies as % of global payments, March 2015



Source: SWIFT and AXA IM Research

So how would the RMB be assessed against the freely useable criterion? The IMF's 2011 report[5] lists a number of indicators for gauging how widely used and widely traded a currency is as part of the freely useable assessment. Under the widely used criteria, the Fund will assess:

1) how much global trade and payments are denominated in that currency;

2) how much official FX reserves are invested in that currency; and

3) how much lending, through banks and capital markets, is conducted in that currency.

4) the volume of FX turnover in that currency,

5) the existence of hedging instruments, and

6) the size of its bid-ask spread.

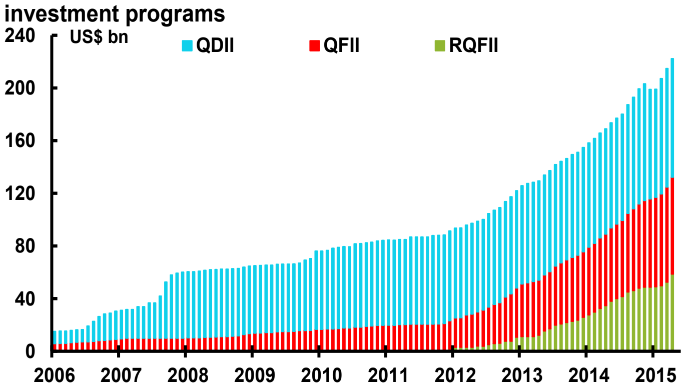
Let us look at how the RMB stacks up against these criteria. As discussed before, China is already the world's largest trading nation, with more than 20% of trades denominated in the RMB, up from virtually zero five years ago. More broadly, **the RMB is now the fifth most used currency in the global payment system** (*Exhibit 3*), and it dominates transactions going through Hong Kong's Real Time Gross Settlement platform.

However, because of the restricted capital account, **non-FDI foreign investment in the RMB – including that from FX reserves – has been more limited.** According to the PBoC, over 200 inter-bank quotas[6] have been granted to foreign institutions as of December last year – around 90 of them are held by public entities, such as central banks and sovereign wealth funds. Market estimates suggest that a total of US$70-120bn investment is current in the RMB, accounting for 0.6-1% of global reserve assets.

Exhibit 4

Cross-border capital flows have risen substantially

China - Accumulative quota approved for cross-border investment programs



Source: CEIC, Bloomberg and AXA IM Research

While this is only half of the reserves currently held in JPY and GBP, **the momentum of capital flows into China's onshore capital markets is very strong** (*Exhibit 4*). Some central banks have reportedly held RMB reserves for many years,[7] but many others are seeking to gain exposures, as China opens up its capital account.

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[3] Liu, B., et al "SDR: One small step for China, one giant leap for CNY", Standard Chartered Global Research, 15 May 2015

[4] Special occasions include: 1) the fight against money laundering and other illegal activities; 2) macroprudential management of external debt to prevent a crisis; 3) countering excessive short-term speculative flows; and 4) mitigating market turbulence and balance of payment problems.

[5] IMF (2011) "Criteria for broadening the SDR currency basket", IMF policy paper, 23 September 2011

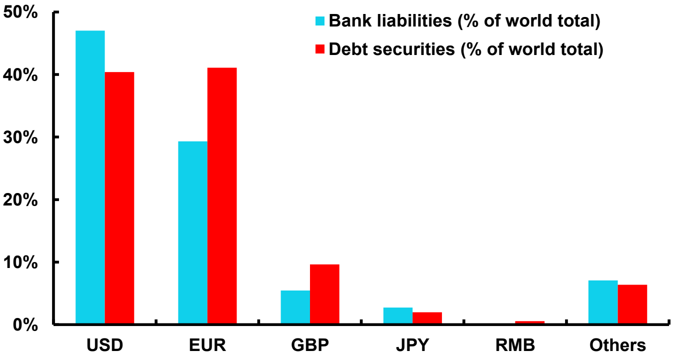
[6] An inter-bank quota allows foreign investors to invest in China's inter-bank markets, which account for more than 90% of total fixed income transactions. The remaining amount occurs on the exchange bond market.

[7] Malaysian and Nigerian central banks have been reporting RMB reserves since 2011. The Bank of Korea started to invest in the RMB since 2012, while the Reserve Bank of Australia announced in 2013 that it would shift 5% of its reserves into the RMB.

Exhibit 5

RMB has not played a big role in international lending because of capital controls

International bank liabilities and debt securities denominated in different currencies



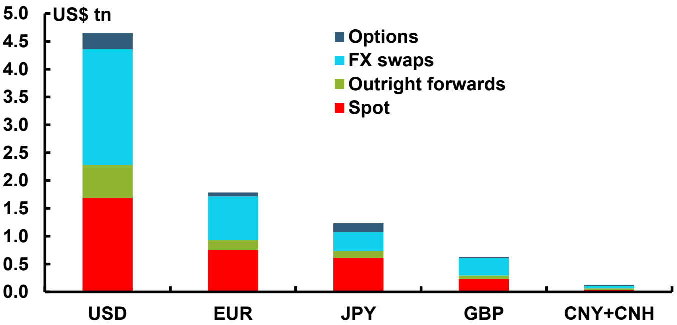
Source: Bank for International Settlements (BIS) and AXA IM Research

Also because of the capital flow restrictions, **the RMB has yet to play a major role in international lending through banks and bond markets** (*Exhibit 5*). In addition, the persistent appreciation of the RMB until last year had discouraged offshore borrowers from tapping into the RMB markets for loans. But as the one-way appreciation comes to an end, and Chinese authorities speed up cross-border lending, the RMB is set to gain more market share in global credit flows.

Exhibit 6

Turnover of RMB transactions remain small compared to SDR currencies

Average daily turnover of spot and derivative trading in SDR and RMB, April 2013



Source: BIS Triennial Survey 2013 and AXA IM Research

Finally, from a trading perspective, **the growing popularity of the RMB has been reflected in the rapidly increased spot market transactions of CNY and CNH, as well as the fast expansion of the derivative markets**. The latest Triennial Central Bank Survey of global foreign exchange markets from the Bank for International Settlements (BIS) showed that daily turnover in the RMB spot and derivative markets reached US$120bn in 2013, quadrupling from the 2010 level. Since then, the volume of market transactions would have increased substantially. However, compared to other SDR currencies, the size of the RMB markets remains small, and liquidity is limited particularly with respect to derivative transactions (*Exhibit 6*).

The end decision will likely be a political one

Overall, **it is a mixed bag performance for the RMB against various metrics for the freely useable criteria.** Despite the substantial improvement on all matrices since the last review, the RMB, strictly speaking, still does not tick all the boxes for being an SDR-eligible currency.

Having said that, **the freely usable criterion is never meant to be a black and white test, but a *subjective* assessment**. In the case of the RMB, the matter comes down to how soon the currency will cross the finishing line for being SDR eligible with continuous liberalisation at the current pace. The IMF managing director, Christine Lagarde, stated recently that "*it is not a question of if, but when [the RMB is included in the SDR]*".[8]

Given the subjectivity of the assessment, **we think what eventually determines the RMB's fate at this year's review will likely be a political decision.** To increase the odds of a favourable outcome, China has started to exert political pressure on the IMF and initiate a diplomatic campaign to win more support for the RMB.

In his recent meeting with Christine Lagarde, the PBoC governor Zhou warned that leaving the currency of the world's second largest economy out of the SDR for another five years will risk the IMF's representativeness in a multilateral global economy. At the same time, Zhou pledged to further open up the capital account by easing the restrictions on cross-border investment and granting foreign investors greater access to domestic markets.[9] If executed properly, these moves could significantly improve the RMB's scoring on many of the freely usable criteria between now and the end of the year.

As for the actual voting, **China needs a 70% majority at the IMF board to get the RMB across the finish line**. China's diplomatic momentum has gathered steam in recent years with strengthened financial ties with other countries through a growing number of offshore RMB centres, central bank swap lines, cross-border investment programs, and the establishment of the AIIB and OBOR[10]. With these, we think the RMB stands a fair chance of amassing enough support for the vote.

While the RMB looks inadequate on the technical scoring, political factors will likely sway the final decision at the IMF Review. In that regard, **we see a greater-than-even**

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[8] http://uk.reuters.com/article/2015/03/20/uk-china-imf-idUKKBN0MG0YJ20150320

[9] Zhou listed six areas of reforms: 1) creating channels for cross-border investments by individual investors; 2) introducing the Shenzhen-Hong Kong Stock Connect program, and allowing non-residents to issue financial products on the domestic markets; 3) revising foreign exchange regulations to reduce approvals; 4) facilitating access to the onshore markets by overseas institutional investors; 5) further encouraging the international use of the RMB; 6) strengthening the framework of risk management and prevention.

[10] AIIB refers to the China-led Asian Infrastructure Investment Bank and OBOR is short for China's One-Belt-One-Road initiatives.

chance for the RMB to be included in the SDR later this year. Even if it fails to make the cut, provided China continues to open its capital account and pursue RMB globalisation, there is a significant chance of an inter-meeting Review that will grant RMB the SDR status before 2020.

First-round effect likely to be limited, but long-term implications are significant

Regardless the decision of this year's review, we think **the immediate impact of the SDR inclusion will be small for the RMB markets.** By immediate impact, we mean the direct investment flows from the reweighting of the SDR basket, which we estimate to be less than US$30bn.[11]

However, **the first-round effect drastically underestimates the long-term implications of China's capital account convertibility and RMB internationalisation.** We think the inclusion of the RMB into the SDR could serve as a powerful endorsement for the RMB's international and reserve currency status. Such a stamp of approval from the IMF could, in turn, trigger a significant, albeit gradual, reweighting of the entire global reserve portfolio, which currently stands at just under US$12tn. Non-public investors could follow, if not lead, the official flows into the RMB, as China's capital markets develop and liquidity improves.[12]

More liberalised capital flows will also, in theory, help China to advance structural reforms, rebalance the economy and improve its financial system. The following benefits are worth noting:

- greater market liberalisation can help China to enhance the efficiency of resource allocation
- increased offshore investment can help domestic investors to better diversify portfolio risks
- greater foreign ownership in Chinese firms can help them to improve their corporate governance
- more participation of foreign institutional investors in the domestic market can improve the structure of the investor base, mitigate herding mentality and volatility that is typical to a retail-dominant market
- finally, increased external influence can exert pressure on the domestic economy, speeding up internal reforms, such as interest rate liberalisation, IPO listing, and even SOE reforms.

We intend to analyse more in depth the potential financial consequences in the medium to long run of both the opening of China's capital account and the inclusion of the RMB in the SDR basket.

[11] SDR portfolio held by the IMF was valued at SDR204bn or US$280, at March 2015. Assuming 10% weight is allocated to the RMB initially, around US$28bn will be invested in the onshore and offshore bond markets.

[12] We will elaborate more on capital flows under a more liberalised capital account for China in a coming report.

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