



Headwind? Tailwind! Examining the Direct Impacts of the RMB's Possible Inclusion into the SDR

Deputy General Manager, E Zhihuan

The International Monetary Fund (IMF) unofficially begins its quintuple review of the SDR basket in recent days, with official result to be expected in October, and implementation at the beginning of 2016. Taking into account of the progress made by the RMB in the past several years including the RMB's use in cross border trade settlement, investment and reserve assets, its approaching the freely usable standard argues strongly for its inclusion into the SDR this time around. The market is generally optimistic about odds of this outcome because it is a matter of when not if. If successful, it will have direct implications to the RMB internationalization in terms of its policy and market drivers.

I. The RMB meets the basic requirements

IMF generally conducts review of its SDR currencies basket every five years. During the last review in 2010, the RMB was the only candidate being seriously considered for inclusion. China already met IMF's first criterion at that time, with its exports of goods and services during the five-year period ending 12 months before the effective date of the revision having the largest value. In 2010, China was the world's third largest exporter of goods and services. Since then, China continues to make headways. Its foreign trade totaled RMB25.42 trillion in 2012, second in the world, and RMB25.83 trillion in 2013, surpassing that of the US to lead the world. In 2014, China retained the crown with foreign trade totaling RMB26.43 trillion. In 2014, China's GDP reached USD10.38 trillion, second only to the US. In the meantime, the foreign direct investment (FDI) China attracts is also second only to the US, and China's outbound direct investment (ODI) is right behind Japan and the US amongst G20. The dollar amount has been basically at par with that of FDI. China's real economy, especially trade and investment growth, sets a solid foundation for the RMB to qualify for the SDR. It is not unreasonable to claim that the RMB internationalization is lagging behind China's economic clout.

The second criterion is that it has to be determined by the IMF under Article XXX (f) to be a freely usable (FU) currency, which concerns the actual international use and trading of currencies. To help make the decision, the IMF refers to four quantitative indicators: the Currency Composition of Official Foreign Exchange Reserves (COFER) compiled by the IMF itself, the international banking liabilities compiled by the Bank of International Settlements (BIS), the international debt securities statistics also compiled by BIS, and the global forex markets turnovers captured by BIS' Triennial Central Bank Survey.

Overall, the RMB's strength lies in offshore deposits and forex trading. In 2014, offshore RMB deposits amounted to RMB2.8 trillion or USD440 billion, making it the fifth largest currency right behind the four SDR currencies. And based on the global forex markets turnovers captured by BIS' Triennial Central Bank Survey, the RMB is ranked the ninth with a market share of 2.2/200. At the end of 2014, it was the sixth most actively traded currency.

The RMB's weakness is in central banks holdings and the RMB international bond market. On one hand, COFER has not been able to single out the RMB in its statistics. It was included in other currencies that accounted for 3.1% of the total in 4Q14. On the other hand, the offshore RMB bond market's size of RMB480 billion at the end of 2014 results in a small share of 0.4% of the total.

It is worth noticing that of these four indicators, three are linked to the offshore market, showcasing the importance of the offshore RMB market's development to its SDR ambition. Moreover, those indicators are not meant to be used mechanically. IMF also emphasizes that the Executive Board's judgment is necessary. Combined with Christine Lagarde's latest comment that it is a matter of when, not if, the RMB makes it into the SDR, and the RMB internationalization's progress in the past several years, the RMB stands a fairly good chance to pass IMF's internal assessment of being freely usable in this year's review.

II. Three scenarios of the RMB's SDR journey

Based on the analysis above, the concept of a freely usable currency concerns the actual international use and trading of currencies, and is distinct from whether a currency is either freely floating or fully convertible. In other words, the facts that the RMB is not yet fully convertible, China still imposes capital controls, and the related RMB exchange rate mechanism shall not be considered obstacles to the RMB's path into the SDR. Recently,

volatilities have surged in the offshore market, offshore RMB deposit growth has eased, and trading in offshore RMB bond market has become subdued. Therefore, attention must be turned to facilitate growth in offshore deposits and bond markets due to their important indicative natures.

Currently, the 85% voting threshold applies mainly to the IMF's decisions on the Fund's governance structure. The US currently has a voting share of 16.75%, meaning it has the veto power on the most important IMF decisions. Other than the freely usable requirement, the RMB's SDR prospects will also hinge upon the US Government and especially the US Congress' stances. Judging from the US Congress' decision to block the 2011 IMF reforms, it is not unreasonable to speculate that the Republican controlled US Congress might block the RMB's inclusion into the SDR even if the Democratic US Government gives the green light, which is essentially the same as the US casting its veto.

In view of this, there are three possible scenarios for the RMB's SDR drive.

The first scenario is that the RMB passes the IMF's internal assessment. Then the IMF makes the recommendation to its members, and everybody including the US Government and Congress gives their blessings. The RMB is then officially included into the SDR.

The second scenario is that the US Congress stands in the way, constituting a technical obstacle.

The third scenario is that the IMF cannot reach a conclusion. Under pressure from the progress made by the RMB internationalization, it may seek another window before 2020 to finalize the RMB's inclusion into the SDR. This is the worst case scenario as it hinders the RMB internationalization by adding uncertainty to the RMB's reputation and its status as an international reserve currency. Under such a scenario, by 2020 the Chinese economic development and China's financial opening are likely to surpass the SDR requirements by wide margins. The RMB will have already made large strides as an international reserve currency. The IMF will face an embarrassing situation of long overdue recognition, a disappointment to many.

Judging from the latest developments, the first and second scenarios are more likely to materialize. If so, it will be a formal recognition of the RMB's international reserve currency

status, which in turn will expedite its internationalization.

III. SDR, the new driver for the RMB internationalization

The SDR is not a truly internationalized supranational currency due to its limited size and issuance, which in turn limits its significance in the international financial markets. If the RMB successfully makes it into the SDR, the significance is more symbolic than practical. But it will certainly help solidify the RMB's international reserve currency status, making it a true international currency, driven first by China's financial regulators, then by multinational financial institutions.

Based on its development pattern in the past decade, the RMB internationalization has been driven by policy in the early stage. Every milestone of the offshore RMB market development was closely related to the loosening regulatory controls in the Mainland. In 2007, the PBOC approved of RMB bond issuance in Hong Kong by eligible Mainland financial institutions, which gave birth to the Dim Sum bond market. Since 2009, the RMB cross-border trade settlement has established a solid foundation for the RMB internationalization. In 2011, the Central Government launched the RMB qualified foreign institutional investors (RQFII) program, which extended the RMB's role in investment and trading. Recently, the Free Trade Zones, Shanghai-Hong Kong Stock Connect and the "One Belt, One Road" strategy are adding new growth impetus to the RMB internationalization in terms of cross border loans and securities trading.

The RMB's inclusion into the SDR will further drive the following developments.

Firstly, it will essentially be an endorsement by the IMF of the RMB's international reserve currency status, which is very significant considering the RMB's convertibility and China's capital controls. It will put the RMB at par to the likes of the US dollar, Euro, Yen and British Pound. With this endorsement, it will remove the obstacles standing in the way of many central banks in their decisions whether to hold the RMB due to its lack of status as an international reserve currency. And global central banks are clear to allocate their funds into RMB assets under proper risk management, which in turn will trigger a buying spree by central banks and sovereign wealth funds alike.

Secondly, it will further facilitate the use of the RMB in cross border trade, investment,

settlement, etc. And China is in the advantage when negotiating pricing commodities such as crude oil and iron ores in the RMB.

Thirdly, it will help lower the borrowing costs by Chinese corporation overseas in their execution of the Go Abroad strategy. And even if China runs into current account deficits, financing it will not be a problem given the RMB being an international reserve currency.

Lastly, it will corroborate the correct path China's reform and opening are on, and will push for further actions such as improving its foreign exchange market mechanism and promoting further financial reform and opening.

IV. SDR inclusion will trigger asset allocation into the RMB

Besides policies, the key to the RMB internationalization lies in market demands. The RMB internationalization has been driven by policy in the early stage and by market demands for RMB products and transactions later, expanding from offshore markets to the globe. The SDR inclusion will trigger demands from reserve asset investment.

Then how much would such demands likely be? According to IMF's statistics, at the end of 4Q14, global official forex reserves holdings stood at USD11.6 trillion, amongst which USD6.09 trillion were allocated reserves in the US dollar, Euro, Yen, Pound Sterling, Swiss Franc, Canadian dollar, and Australian dollar. In 2013, IMF expanded the coverage of its COFER to list the Canadian dollar and Australian dollar individually. They accounted for 1.4% and 1.5% respectively of the world's allocated forex reserves holdings in 2012. Using 1.5% as a threshold, it amounted to about USD91.3 billion out of the USD6.09 trillion of the total allocated official forex reserves holdings at 4Q14. Using the prevailing exchange rate of 1 US dollar to 6.20 Yuan, it equals to RMB570 billion. And applying the Canadian dollar and Australian dollar's average weight at 4Q14 would result in USD110 billion or RMB682 billion. Based on this calculation, it is estimated that once the RMB is included into the SDR, the market demands for RMB assets as official reserves holdings would amount to RMB680 billion at least, which far exceeds the current outstanding balance of offshore RMB deposits and bonds combined.

Currently, there are reportedly more than 40 central banks around the world that have already or planned to hold RMB assets in their forex reserves. They can add to the exposure

through offshore markets, QFII, RQFII and China's interbank bond market. With regard to the latter, so far there are more than 20 central banks including Switzerland, France, Japan, Austria, Australia, and Singapore, etc., who are granted quota for China's interbank bond market investment. And according to public disclosure, global central banks holdings of RMB assets currently amount to about RMB140 billion. In other words, there are potential demands for RMB assets in the offshore market in the hundreds of billions of Yuan still.

V. SDR inclusion will boost growth in offshore financial and trading businesses

Shortly after the SDR inclusion, asset allocation into the RMB will largely take place in the offshore market, which in turn will boost its financial and trading activities.

Up till now, RMB clearing in the offshore market exceeds RMB trade settlement by a wide margin, suggesting that investment related financial and trading activities dominate the offshore market. In 2014, RMB RTGS clearing reached RMB170.3 trillion. In the same period, Hong Kong's trade settlement in the RMB totaled RMB6.26 trillion. Even though its growth was significant and accounting for the majority of trade settlement in the RMB, it was marginal when compared to the RMB RTGS.

There is no doubt that SDR inclusion will further boost such investment related financial and trading activities. As for foreign exchange transactions, according to Reuters, London has surpassed Hong Kong and accounts for 44% of global RMB transaction volume. Transactions of deliverable futures in London rose 127% to averaging USD42.4 billion per day. Besides Hong Kong Exchanges and Clearing, RMB futures contracts have been launched on the CME, Singapore Exchange, and Brazil's BM&FBOVESPA.

To summarize, if the RMB successfully makes it into the SDR, it will certainly help solidify its international reserve currency status, making it a true international currency. Moreover, it will push for further actions such as the RMB's convertibility and China's exchange rate reform, and help promote further financial reform and opening.

主要經濟指標 (Key Economic Indicators)

| 一. 本地生產總值 GDP | 2013 | 2014 | 2014/Q4 | 2015/Q1 |
|--|--------|--------|---------------|---------------|
| 總量 (億元) GDP(\$100 Million) | 20,961 | 21,446 | 6,127 | 5,724 |
| 升幅 (%) Change(%) | 2.9 | 2.3 | 2.4 | 2.1 |
| 二. 對外貿易 External Trade | 2013 | 2014 | 2015/3 | 2015/1-3 |
| 外貿總值 (億元) Total trade(\$100 Million) | | | | |
| 港產品出口 Domestic exports | 544 | 553 | 40 | 114 |
| 轉口 Re-exports | 35,053 | 36,175 | 2,921 | 8,246 |
| 總出口 Total exports | 35,597 | 36,728 | 2,961 | 8,361 |
| 進口 Total imports | 40,607 | 42,190 | 3,423 | 9,548 |
| 貿易差額 Trade balance | -5,010 | -5,463 | -462 | -1,187 |
| 年增長率 (%) YOY Growth(%) | | | | |
| 港產品出口 Domestic exports | -7.6 | 1.7 | -21.6 | -10.1 |
| 轉口 Re-exports | 3.8 | 3.2 | -1.5 | 2.5 |
| 總出口 Total exports | 3.6 | 3.2 | -1.8 | 2.3 |
| 進口 Imports | 3.8 | 3.9 | -2.7 | 1.4 |
| 三. 消費物價 Consumer Price | 2013 | 2014 | 2015/4 | 2015/1-4 |
| 綜合消費物價升幅 (%) Change in Composite CPI(%) | 4.3 | 4.4 | 2.8 | 4 |
| 四. 樓宇買賣 Sale & Purchase of Building Units | | | 2015/4 | 2015/1-4 |
| 合約宗數 (宗) No. of agreements | 70,503 | 81,489 | 6,223 | 28,804 |
| 年升幅 (%) Change(%) | -29.9 | 15.6 | 3.5 | 44 |
| 五. 勞動就業 Employment | | | 2015/1-2015/3 | 2015/2-2015/4 |
| 失業人數 (萬人) Unemployed(ten thousands) | 11.84 | 14.95 | 12.73 | 12.75 |
| 失業率 (%) Unemployment rate(%) | 3.4 | 3.2 | 3.3 | 3.2 |
| 就業不足率 (%) Underemployment rate(%) | 1.5 | 1.5 | 1.4 | 1.3 |
| 六. 零售市場 Retail Market | | | 2015/3 | 2015/1-3 |
| 零售額升幅 (%) Change in value of total sales(%) | 11.0 | -0.2 | -2.9 | -2.3 |
| 零售量升幅 (%) Change in volume of total sales(%) | 10.6 | 0.6 | 0.8 | 0 |
| 七. 訪港遊客 Visitors | | | | |
| 總人數 (萬人次) arrivals (ten thousands) | 5,430 | 6,077 | 441 | 1,542 |
| 年升幅 (%) Change(%) | 11.7 | 11.9 | 8.7 | 4.9 |
| 八. 金融市場 Financial Market | | | 2015/3 | 2015/4 |
| 港幣匯價 (US\$100=HK\$) | 775.4 | 775.6 | 775.5 | 775 |
| H.K. Dollar Exchange Rate (US\$100 = HK\$) | | | | |
| 貨幣供應量升幅 (%) change in Money Supply(%) | | | 2015/2 | 2015/3 |
| M1 | 9.7 | 13 | 4.2 | 27.5 |
| M2 | 12.3 | 9.5 | 8.3 | 11.9 |
| M3 | 12.4 | 9.6 | 8.3 | 11.8 |
| 存款升幅 (%) Change in deposits(%) | | | | |
| 總存款 Total deposits | 10.6 | 9.7 | 8.8 | 13.3 |
| 港元存款 In HK\$ | 5.1 | 9.3 | 6.3 | 16 |
| 外幣存款 In foreign currency | 16.2 | 10.1 | 11.2 | 10.7 |
| 放款升幅 (%) in loans & advances(%) | | | | |
| 總放款 Total loans & advances | 16.0 | 12.7 | 6.6 | 11.7 |
| 當地放款 use in HK | 13.8 | 12.1 | 4.3 | 13.8 |
| 海外放款 use outside HK | 21.4 | 14.2 | 12.1 | 13.6 |
| 貿易有關放款 Trade financing | 43.8 | -1.4 | -6.7 | -8.5 |
| 最優惠貸款利率 (%) Best lending rate (%) | 5.0000 | 5.0000 | 5.0000 | 5.0000 |
| 恆生指數 Hang Seng index | 23,306 | 23,605 | 24,823 | 24,901 |