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China's long road to Reserve Currency supremacy

By Jan Dehn

- RMB completes the process of SDR inclusion – and embarks upon the longer road to Reserve Currency Supremacy
- Colombians reject the terms of Santos' plan for peace with FARC
- Brazil's current account improves again as PT suffers heavy losses in municipal elections
- Hungary's referendum on refugees weakens the EU further
- Mexico hikes as markets insist on trading the US election in the Mexican currency market

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.9	–	-1.50%
MSCI EM Small Cap	12.0	–	-1.11%
MSCI Frontier	10.3	–	1.12%
MSCI Asia	12.6	–	-1.44%
Shanghai Composite	12.5	–	-0.94%
Hong Kong Hang Seng	7.7	–	-2.19%
MSCI EMEA	9.7	–	-1.58%
MSCI Latam	13.7	–	-0.78%
GBI-EM-GD	6.18%	–	-0.01%
ELMI+	3.48%	–	0.18%
EM FX spot	–	–	-0.03%
EMBI GD	4.99%	338 bps	-0.08%
EMBI GD IG	3.86%	219 bps	-0.17%
EMBI GD HY	6.58%	507 bps	0.02%
CEMBI BD	4.94%	346 bps	-0.05%
CEMBI BD IG	3.81%	233 bps	-0.03%
CEMBI BD Non-IG	6.76%	529 bps	-0.08%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.4	–	0.20%
1-3yr UST	0.78%	–	0.04%
3-5yr UST	1.15%	–	0.08%
7-10yr UST	1.60%	–	0.23%
10yr+ UST	2.32%	–	0.60%
10yr+ Germany	-0.12%	–	0.58%
10yr+ Japan	-0.07%	–	0.30%
US HY	6.17%	480 bps	0.39%
European HY	4.38%	486 bps	-0.24%
Barclays Ag	–	245 bps	0.03%
VIX Index*	13.75	–	-0.75%
DXY Index*	95.55	–	0.25%
EURUSD	1.1234	–	-0.18%
USDJPY	101.31	–	0.98%
CRY Index*	186.32	–	3.22%
Brent	50.1	–	5.72%
Gold spot	1316	–	-1.62%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

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- **China:** Make a note of the date 1st October 2016 as the day China's currency, the RMB, became the first Emerging Markets (EM) currency to attain global reserve currency status. In years to come it will also be seen as the day the RMB embarked on its long journey to become the world's pre-eminent global reserve currency.

The IMF included the RMB in its SDR basket with a weight of 10.9%. The basket weights of EUR and GBP were reduced to make room for RMB, while the USD and JPY broadly maintained their weights. The UK has already benefited significantly from its gesture to China by securing material Chinese investment in the Hinkley nuclear power plant.

The RMB's inclusion in the SDR is particularly important for central banks, which now have access to a reserve currency, whose integrity is not undermined by QE and where the government in question pays positive nominal and real yields on its bonds. This makes the RMB unique among the SDR currencies.

SDR inclusion is only the beginning for the RMB's journey, however. The real significance of RMB's SDR inclusion will only become fully apparent as China's growing economic importance becomes more widely accepted. Size matters in global finance. In particular, financial markets prefer to benchmark themselves against the largest and most liquid markets. This is why, for example, the US Treasury market and the US dollar rapidly replaced the UK Gilt and Pound Sterling as global benchmarks for fixed income and currencies in the interwar years, where the US economy dramatically outpaced the UK economy.

China is now in the process of pulling a similar trick on the US. Chinese growth is likely to eclipse US growth for several decades to come for a number of reasons. It is important that China is reforming, while US productivity is declining sharply, but China also starts out with a much lower level of per capita income and a much higher savings rate. Higher savings means that China's investment rates and hence her growth rates will be structurally higher, while a lower starting level of per capita income will ensure that the basic forces of economic convergence continue to propel China forward at much greater speed than the very mature US economy.

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The effect of these forces cannot be exaggerated. Realistically, China's per capita GDP will catch up with US per capita GDP sometime between year 2040 and year 2051. This is significant, because China's population is more than four times larger than that of the US. Hence, when the two countries have the same per capita income the Chinese economy will in fact be more than four times larger than the US economy.

Clearly, these types of long-term projections always depend on the underlying assumptions. Early catch up (i.e. in 2040) would require that both China and the US economy continue to grow at the same per capita growth rates since 1980 (Scenario 1 in the table below). In reality, however, both countries have been growing at progressively slower rates over the last few decades. It is arguably more realistic to assume that both countries' growth rates will continue to decelerate at the current pace. Even so, China will catch up with US living standards just five years later, i.e. by 2045 (Scenario 2). What if these assumptions are also too optimistic? Suppose that China grows only 5% per year and the US only 1% per year. In that scenario, China will still catch up with US living standards by 2050 (Scenario 3). Finally, just as a sense check, if China grows at the IMF's expected medium-term growth rate projections, then catch up will happen by 2051, i.e. not materially out of line with the bearish growth scenario.

Fig 1: **The Rise of China: Year when Chinese per capita GDP overtakes US per capita GDP**

Per capita growth scenario	US per capita growth rate	China per capita growth rate	Year China per capita GDP overtakes US per capita GDP
Scenario 1: 41-year average	2.6	9.2	2040
Scenario 2: 41-year trend	1.4	6.4	2045
Scenario 3: Pessimistic global growth	1.0	5.0	2050
Scenario 4: IMF medium-term projection	2.0	6.0	2051

Source: Ashmore, IMF.

The conclusions from these scenario analyses should be clear: China's rise to global economic pre-eminence is a near-mathematical certainty. As China continues to gain clout her government bond and currency markets will catch and then overtake US markets eventually to emerge as the most dominant reference markets for global investors. US markets will remain very large and very important, but second to China's. Europe's markets will become marginalised in the global context, unless European countries come together in a political and economic union with a single centralised government with unified fiscal and monetary policies, a prospect that is currently receding due to rising nationalistic fervour.

China's domestic investors are far more in tune with the bullish outlook for China than most investors outside of the country. One reason for this imbalance may be that global investors are still hampered by the continuing failure of index providers to include China's onshore markets in their main equity and fixed income benchmarks. However, we think inclusion is only a question of time and RMB inclusion in the SDR should increase the odds of index inclusion within the next twelve months.

Why has China pushed so hard to get its currency into the SDR? China correctly takes the view that its investment and export-led growth model is now past its sell-by date. This growth model hinged on the existence of debt fuelled consumption in the West and the ability to weaken the RMB versus Western currencies. Debt fuelled demand is now far less likely and QE policies will ultimately weaken Western currencies, so China must turn to other growth engines. Fortunately, with a savings rate of 50% China has a bright future ahead as a consumption-led economy.

The challenges associated with transitioning from an export/investment growth model to a consumption-led growth model are considerable, though temporary. Deep reform is required. For example, higher consumption will eventually erode China's large current account surplus, so China will eventually need to finance imports by importing capital. This is precisely why China is liberalising its capital account. Joining the SDR is part of this effort, because reserve currencies tend to be more stable than non-reserve currencies, which is clearly a desirable quality if you have to rely more on external financing.

However, nearly all other sectors of the Chinese economy also require reform as the country turns to consumption-led growth. Importantly, China has to develop new, effective means of controlling consumption in order to have overall control of the aggregate demand. This is why the government has set in motion a raft of measures to improve the transmission mechanism for monetary policy, including liberalising interest rates and converting non-tradable bank loans into municipal bonds as part of efforts to building a liquid domestic bond market. Domestic savings institutions are pivotal here –there will be ongoing restructuring of the financial sector, including the creation of a large mutual fund industry as well as better insurance and pension systems. As these building blocks of China's domestic capital market are put in place, China will gradually dismantle access quotas and other controls on cross-border flows.

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A third plank of China's ongoing reforms take aim at raising domestic productivity. Here too the rationale is logical: China can only increase domestic demand – consumption – without sacrificing macroeconomic stability provided it also increases domestic supply, i.e. raises productivity. The productivity enhancing measures are many, but the most prominent ones include modernising state-owned enterprises, liberalising prices, expanding the Judiciary to give better protection for intellectual property rights, broadening the rule of law and use of contracts, implementing environmental protection measures, etc.

Global investors are not paying enough attention to – and perhaps not fully understanding – the seriousness and profundity of China's economic reform efforts. While reforms create a great deal of uncertainty, which in turn results in postponement of consumption and investment decisions – and hence slows the rate of economic growth – it is critical to bear in mind that the reforms also hold the key to high sustained growth in China for decades to come, especially when the full ramifications of myopic policies in the West become evident.

In other Chinese news, the current account surplus rose to USD 64.1bn in Q2 2016 from USD 59.4bn in Q2 2015, the Caixin Manufacturing PMI Index increased marginally from 50 in August to 50.1 in September and industrial profits rose 19.5% yoy, up from 10.5% yoy in August. China's official manufacturing PMI was unchanged at 50.4 in September.

- Colombia: On Sunday Colombian voters narrowly rejected terms of President Juan Manuel Santos' peace deal with the FARC rebel group. Despite the rejection of the deal on offer, however, all the involved parties, including the FARC, President Santos and the factions led by former President Alvaro Uribe, which were opposed to the deal, all indicated that they remain in support of a peace accord. This means that the most likely path forward is that peace talks will resume in order to find a new formula that is palatable to a majority of Colombians. However, it seems unlikely that this can be achieved quickly and probably not within Santos' term in office which expires in 2018. The result puts former President Uribe in the ascendency. Having adopted a hard line against the FARC, demanding tougher terms, he is now on the right side of the popular mood. Santos will also need his support for a vital tax reform, which the government hopes to pass this year. The tax reform is key, because the government delayed important economic adjustment to lower oil prices in order to maximise chances of winning the referendum. The tax reform would increase revenues by 2% of GDP, while lowering the tax burden on the corporate sector. Two ratings agencies have Colombia on negative outlook and could downgrade the sovereign (currently two notches above junk at BBB). The question now is whether Santos recognises that the right choice is to shift the focus back on the economy and to leave the peace deal to the next generation of Colombian leaders. In other news, the central bank left rates unchanged at 7.75%. The referendum result could make it harder for the central bank to cut rates.

- Brazil: Sunday's municipal elections across Brazil delivered a hard blow against the parties involved in the Petrobras investigation known as Lava Jato ('car wash'). The PT, party of impeached president Dilma Rousseff, saw its leaders elected in cities across Brazil slashed from 630 to just 256 and will dispute second round elections in only seven cities. PT lost Sao Paulo, the largest city in Brazil. The opposition PSDB party, usually regarded as market-friendly, emerged as the main winner with mayors elected in 791 municipalities compared to 686 cities four years ago. Little-known until yesterday, Joao Doria (PSDB) was elected mayor of Sao Paulo in the first round with 53% of the vote. Doria is not a politician. Rather, he was handpicked by Governor Geraldo Alckmin to challenge the "big wigs" in the PSDB. Doria now owes his political ascendancy to current state governor Alckmin and began repaying his debt by announcing Alckmin as a presidential candidate for 2018. To run for PSDB, however, Alckmin (also PSDB) will have to challenge Aecio Neves, who is unlikely to want to give up his position as leader of the party. Hence, Alckmin may have to form a new party or change to another party. Finally, although the PMDB party lost Rio de Janeiro it maintained its overall hegemonic position as the largest party in the county. This is impressive, given President Michel Temer's low popularity and the many PMDB legislators involved in the Lava Jato probe. Hence, the main take-aways from the municipal elections can be summarised as follows: (a) PSDB's chances of winning the next presidential election have been given a big boost; (b) PT's chances of coming back have been dealt a severe blow; and (c) the current Temer administration looks strong enough to continue on its current reform path. In other Brazilian news, the current account deficit narrowed to just USD 0.6bn in August, the strongest level achieved since 2007. This compares to a deficit of USD 2.6bn in the same month of 2015. BTG Pactual, the Brazil-based investment bank, was upgraded to BB- from B+ by Standard & Poor's. BTG became a symbol of the Carwash Scandal and Brazil's steep cyclical adjustment. The bank's ratings upgrade is now one of a number of recent indications that Brazil is emerging from the trough. Falling inflation, stronger external balances, reforms and gradually stronger economic indicators are bringing the central bank closer to starting the rate cutting cycle. The policy rate in Brazil is 14.25%. The central bank's forecast is for inflation to fall to just 4.4% in 2017.

- Hungary: Prime Minister Viktor Orban will regard the 98% support he received in a referendum on EU-imposed quotes for refugees as convincing victory despite the fact that the turnout (43%) was not sufficient for the result to be valid. Orban said the rejection of EU-imposed quotas for refugees will now be enshrined in Hungarian Law via a change in the country's constitution. The result of the referendum marks another setback for the European Union, whose members are turning increasingly nationalistic in response to the economic crisis of 2008/2009. Similar sentiment has recently found expression in border closures between Denmark and Sweden and UK's recent decision to leave the European Union.

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- Mexico: Banxico hiked rates by 50bps to 4.75%. The decision followed prolonged MXN weakness. The Mexican peso was the market's favourite way to express a negative view on EM currencies between 2013-2015, and has been caught up in US election-related noise this year due to Donald Trump and Hillary Clinton's contrasting emotions when it comes to Mexico and its people. Speculators have begun to argue that the continuing weakness of the Peso must be due to some hidden fundamental vulnerability. We do not share this view. This type of pseudo speculation about possible fundamental vulnerabilities often emerges when speculators want to extend an already stretched trade a bit further. Mexico's economic and political problems are well-known to investors. They are not unmanageable and do not constitute the reason for the Peso's weakness, in our view.

- Argentina: Alejandro Werner, IMF's director for the Western Hemisphere, issued a strong statement of support of the economic policies of the Macri Administration. The cornerstones of Macri's policies include a gradual tightening of monetary policy supported by increase fiscal spending financed by debt and investment-friendly supply-side reforms. The central bank last week adopted the seven-day rate as the main policy instrument, another step towards normalisation of monetary policy after the disastrous management of the central bank during the Kirchner administration. Finance Secretary Luis Caputo announced that the government will turn to greater reliance on domestic financing sources going forward.

- Venezuela: PDVSA, the national oil company, brought the terms of a proposed swap of near-term liabilities into longer-dated bonds into line with current markets and thereby sharply increased the odds of participation by bond holders, in our view. The deadline for the swap under the revised conditions was extended from 29 September to 6 October.

- India: India has jumped sixteen places in the World Economic Forum's Global Competitiveness, where the country now ranks 39 out of 138 countries. Prime Minister Modi has cut red tape and recently passed a major reform of the tax system. The government announced that INR 652bn (USD 10bn or about 0.4% of GDP) has been declared under an Income Declaration Scheme (IDS). The scheme has been dramatically more successful than previous schemes. INR and Indian bonds experienced moderate volatility in the past week due to a military confrontation with Pakistan in Kashmir.

Snippets:

- Chile: Industrial production rose at a rate of 2.8% yoy versus 0.2% yoy expected in August.
- Indonesia: With another six months left to run, the government has so far collected IDR 95trn from a tax amnesty. This makes it likely that the final tally will be significantly higher than anticipated (IDR 51-100 trn).
- Malaysia: The budget balance swung into surplus in August due to 27% yoy revenue growth and modest spending. The Markit PMI manufacturing index improved to 48.6 in September from 47.4 in August.
- Mongolia: The government has formally requested IMF support paving the way for an IMF mission to visit Ulaanbaatar late this month.
- Poland: There was no inflation in September, according to official data. On a yoy basis, CPI inflation rose marginally from -0.8% in August to -0.5% in September.
- South Africa: The trade deficit widened more than expected in August following very strong numbers in recent months. The three-month moving average trade surplus ZAR 2.7bn in August compared to a deficit of ZAR 1.71bn in August of 2015.
- Taiwan: The central bank left rates unchanged at 1.375%. September's PMI rose to 52.2 from 51.8 in August.
- Thailand: The current account surplus increased to USD 3.8bn in August from USD 3.6bn in July, driven mainly by an increase in the trade balance of USD 200m relative to last month. Inflation in September was 0.38% yoy versus 0.40% yoy expected.
- Vietnam: Real GDP growth accelerated to 6.4% yoy in Q2 2016 from 5.6% yoy in Q2 2015.

Global backdrop

There were several interesting developments in the global backdrop last week of which only the former has any meaningful fundamental impact on a subset of EM economies.

- OPEC agreed to cut production by some 250K-700K barrels. The production cut is small and may not even be implemented, given OPEC's record of compliance. Even so, oil prices rose sharply as the market now prices in the risk associated with an active OPEC cartel.
- US election uncertainty declined marginally as Hillary Clinton defeated Donald Trump in the first TV debate, but Trump's attacks on Fed Chairwoman Yellen served to highlight that it will be all change at the Federal Reserve if he wins in November.

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Global backdrop

- Equity markets weakened on renewed concerns about European banks, notably Deutsche Bank. Unlike American banks, European banks were never recapitalised following the subprime crisis. Commerzbank, another large German bank, announced that it is to lay off 10,000 jobs. Two German Landesbanks were the first banks to go bust in the Subprime Crisis of 2008/2009.
- The US marginalised itself further on the global stage by upsetting one of its strongest allies in the Middle East, Saudi Arabia. The so-called "9/11 Bill" lifts Saudi sovereign immunity and therefore exposes the sovereign to legal prosecution in US courts. The Philippines is also turning away from the US, while the failure to lift sanctions on Iran is also likely to drive that country into other arms, in our view. Finally, tensions with Russia are putting strains on US relations with Europe given the latter's complete dependence on Russian gas.
- The probability of a December Fed hike rose marginally last week to 59% from 55%. US data was mixed, but core PCE inflation picked up to 1.7% yoy from 1.6% yoy. The Bloomberg consensus for US real GDP growth has dropped to 1.5% for 2016 compared to 2.6% last year.
- UK Prime Minister Theresa May said she would invoke Article 50 no later than the end of March 2017 as the government appears to move closer and closer to a 'hard Brexit' position. This does not bode well for growth and the currency, in our view.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.32%	16.29%	17.20%	-0.23%	3.38%
MSCI EM Small Cap	1.32%	9.22%	12.86%	1.53%	5.01%
MSCI Frontier	2.61%	2.22%	0.99%	-0.28%	4.50%
MSCI Asia	1.65%	12.73%	17.17%	3.74%	7.17%
Shanghai Composite	-2.54%	-13.36%	0.48%	13.95%	7.60%
Hong Kong Hang Seng	0.61%	3.45%	6.26%	1.34%	5.49%
MSCI EMEA	2.98%	18.34%	8.69%	-6.60%	-0.48%
MSCI Latam	-0.82%	32.45%	28.96%	-7.68%	-3.70%
GBI EM GD	2.02%	17.07%	17.06%	-2.57%	0.06%
ELMI+	0.90%	7.40%	7.25%	-2.70%	-0.79%
EM FX Spot	0.89%	5.56%	3.93%	-9.44%	-6.91%
EMBI GD	0.40%	14.77%	16.20%	8.19%	7.75%
EMBI GD IG	-0.35%	12.94%	14.04%	7.17%	6.32%
EMBI GD HY	1.27%	16.72%	18.61%	9.32%	9.70%
CEMBI BD	0.15%	11.11%	11.61%	6.39%	7.04%
CEMBI BD IG	-0.06%	8.71%	8.90%	6.18%	6.24%
CEMBI BD Non-IG	0.50%	15.28%	16.28%	6.51%	8.84%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.02%	7.84%	15.42%	11.14%	16.35%
1-3yr UST	0.18%	1.53%	0.96%	0.74%	0.67%
3-5yr UST	0.34%	3.46%	2.29%	2.29%	1.66%
7-10yr UST	0.24%	7.02%	5.49%	5.22%	3.41%
10yr+ UST	-1.39%	14.69%	12.93%	11.73%	5.52%
10yr+ Germany	0.45%	17.36%	15.54%	13.50%	9.40%
10yr+ Japan	-0.15%	11.77%	14.60%	8.09%	6.63%
US HY	0.67%	15.11%	12.73%	5.28%	8.33%
European HY	-0.67%	7.36%	8.67%	6.54%	11.81%
Barclays Ag	-0.19%	8.52%	8.59%	5.56%	5.63%
VIX Index*	3.46%	-24.49%	-34.34%	-22.18%	-69.75%
DXY Index*	0.09%	-3.13%	-0.30%	19.81%	20.29%
CRY Index*	0.00%	5.77%	-4.01%	-34.75%	-37.14%
EURUSD	-0.05%	3.48%	0.41%	-17.51%	-14.74%
USDJPY	-0.02%	-15.62%	-15.90%	4.16%	32.21%
Brent	2.04%	34.28%	4.01%	-54.07%	-50.78%
Gold spot	0.04%	24.01%	15.90%	-0.04%	-20.63%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.
Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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