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RMB in the SDR: The Start of a New Era

By Jan Dehn

The inclusion of the Chinese renminbi (RMB) in the IMF's basket of reserve currencies, the Special Drawing Rights (SDR), marks the first time that an Emerging Markets (EM) currency has been given the go ahead to become a global reserve currency. The implications are many and far reaching - this note highlights a few.

Firstly, in our view, Central Banks now have genuine insurance against the QE currencies. Some 93% of global FX reserves (with known allocations) are invested in the currencies of the four QE countries of the US, Eurozone, Japan and the UK. Since QE policies in these four countries have generally not been accompanied by serious efforts to deleverage or structurally reform it is likely that QE policies will ultimately prove inflationary and/or debase the currencies in question. With the introduction of the RMB into the SDR Central Banks and other institutional investors now have an 'officially sanctioned' non-QE currency in which to park reserves to protect the real value of their assets. It is an added bonus that Chinese government bonds pay a much higher real yield than bonds in other reserve currencies.

Secondly, the technical position for RMB is very strong. Most Central Banks and institutional investors are currently heavily underexposed to RMB. Yet, the Renminbi enters the SDR with a weight of 10.92%, which is the third largest weight and puts RMB ahead of both JPY and GBP. Based on IMF data, Central Banks currently allocate 3.8% and 4.7% of publicly allocated reserves to JPY and GBP, respectively. We think RMB's share in global reserves is bound to exceed these levels. Moreover, RMB should eventually challenge the EUR's weight in the SDR (20.5%) and over the longer horizon, given China's destiny to become the world's largest economy and its largest financial market, eventually surpassing even the US dollar's weight in the SDR to become the world's dominant reserve currency.

Thirdly, China's financial clout will rise as the use of the RMB for settlement of trade and financial transactions becomes more widespread. China's reserves will gradually become surplus to requirement, de facto 'excess reserves' as demand for RMB rises outside of China. China will therefore inevitably become a sell of US Treasury securities and other conventional reserve assets that pay low or negative real yields. The excess reserves instead become available for investment in infrastructure and other long-term projects around the globe. Having said that, we think China will be on its best behaviour in the next 12 months as RMB is being phased in to the SDR system and in general we expect China to continue to act very responsibly in its international financial dealings beyond the formal SDR adoption date in October 2016.

The change in the SDR basket weights shows that Europe and UK are investing very heavily in their relationship with China. We think this policy will pay off handsomely over time. The strongest indication of the value Europe and the UK place on relations with China is how much they were willing to reduce their weight of their currencies in the SDR basket in order to accommodate the RMB's inclusion. The GBP's weight in the SDR basket was reduced by no less than 28%, while the EUR's share declined by 17%. By contrast, the US and Japan were only willing to countenance a reduction in the weights of their currencies of 0.5% and 12%, respectively. The price Europe and the UK have paid is lower than it might seem. Actual allocations to GBP and EUR in global reserves were and remain well below the SDR weights. Besides, for the UK the investment in relations with China has already started to pay off. China recently made a major investment in the UK nuclear industry, while London is set to become a very important offshore RMB trading hub. Europe hopes that China can make significant investments in energy infrastructure to help Europe wean itself off its dependence on Russian gas.

Table: Global reserve currencies - SDR weights, current reserve allocation and bond yields

Currency	New SDR weights	Old SDR weights	% change new versus old weights	% weight in known global FX reserves	5 year bond yield (%)	Core inflation (% yoy)	Real yield (%)
USD	41.7	41.9	-0.5%	63.8	1.6	1.9	-0.3
EUR	30.9	37.4	-17.4%	20.5	-0.2	1.1	-1.3
RMB	**10.9**	**0.0**	**-**	**-**	**2.9**	**1.5**	**1.4**
GBP	8.1	11.3	-28.3%	4.7	1.1	1.1	0.0
JPY	8.3	9.4	-11.7%	3.8	0.0	0.7	-0.7
Others	-	-	-	7.2	-	-	-

Source: IMF, Ashmore, Bloomberg.

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What are the next priorities on China's path towards full capital account liberalisation?

In addition to pushing ahead with deepening the domestic bond market, we think the next focus will be equity markets. In 2015 the volatility in the onshore stock market shows that there are far too few institutional investors actively participating in the Chinese stock market. The thin institutional investor base means that the market is dominated instead by retail investors, which often have no idea how to price stocks and therefore produce fertile conditions for speculators pushing markets far away from fair value. Earlier in 2015, frenzied speculation surrounded China's inclusion in the MSCI and FTSE benchmark equity indices only to precipitate a bust when index inclusion was delayed. Now that the 2015 target of securing SDR inclusion for the RMB has been reached, we think China's authorities will turn their attention back to the equity market by addressing, among other things, the specific concerns that led MSCI and other index providers to put on hold their decisions to include A-shares in its main index. We think China will continue to aggressively move towards the opening up of its capital account. This month MSCI is expected to include a number of Chinese companies trading on US exchanges via ADRs into its US indices.

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