Global Economics & Markets Research
Company Reg No. 193500026Z

Suan Teck Kin Suan.TeckKin@UOBgroup.com

Wednesday, 05 August 2015

Flash Notes

China: IMF Throws Roadblock On RMB's SDR Ambition

- IMF policy paper proposes the delay of this year's Special Drawing Rights (SDR) assessment to Sep 2016, as it highlights a number of considerations whether the RMB meets the "freely usable" criterion
- We see the latest development from IMF merely delays, rather than derails, China's ambition to have the RMB included in the SDR, which is seen as important from China's point of view.
- For now, we still see China maintaining a largely stable exchange rate into 2016, although we still think there is a chance of widening of trading bands as well as potential for more FX volatility as see in early 2015. We maintain our USD/CNY forecast at 6.23 for end-3Q2015 and 6.20 for end-2015.

IMF To Delay SDR Review To Sep 2016

Ahead of IMF's quinquennial (once every five years) review of the Special Drawing Right (SDR) basket that is due by end of 2015, the institution released a policy paper on 3 Aug 2015 ("Review of the Method of the Valuation of the SDR—Initial Considerations") after IMF's Executive Directors held an informal meeting on the review of the SDR basket.

The IMF paper proposed that the evaluation of China RMB's admission into the SDR basket be delayed to 30 Sep 2016, due to concerns by SDR users that introducing a new basket on the first trading day of the year (if a positive decision were to be made in late 2015) can expose them to increased risks and costs. The delay could also help reduce uncertainty for SDR users and facilitate continued smooth SDR-related operations, while allowing adequate time to make necessary changes to contractual arrangements, including in the event that IMF Executive Board ultimately decides to add a new currency to the basket.

While China meets the criterion of "exports gateway", as export shares are a main criterion for currency selection for the SDR basket, the IMF paper raises a number of issues that focuses on the key criterion: "freely usable", a criterion for currency selection established in 2000 to recognize the importance of financial transactions for SDR valuation purposes.

IMF defines "freely usable" as (i) widely used to make payments for international transactions and (ii) widely traded in the principal exchange markets. In the paper, a number of measures were shown to assess both the "widely used" and "widely traded" definitions. The gist of it is that the RMB is largely below that of most major currencies, although incomplete and unavailability of data also obscures the true picture which the IMF says it will work towards improving.

For instance, under the "widely used" definition, the RMB's share in official foreign assets (OFA) amounted to just 1.1% at number 7 in 2014, below that of Canadian dollar's share of 2%, and Australia dollar's 2.1%, and Japanese yen's 3.4%. In terms of international debt securities outstanding, RMB's share accounted for just 0.6% at number 8 in 1Q2015, below Canadian dollar's 0.9% share and Australian dollar's 1.3%.

For the "widely traded" definition, IMF points out that at the 2013 BIS Triennial Survey, the 4 SDR currencies (USD, EUR, GBP, JPY) accounted for 80% of the total FX turnover, while the RMB accounted for just 1.1% (daily average total turnover of US$120bn) share, up from 0.4% share (or US$34bn) in 2010, but trailing behind the likes of CHF, AUD, CAD, Mexian peso, in addition to the SDR currencies. Spot turnover for RMB was even lower at 0.8% share (or US$34bn) at the 2013 survey. While IMF acknowledged that RMB's share in FX turnover has been rising, and is estimated to have reached US$250bn average daily by 2015 (on a net-gross basis, vs. BIS' survey using net-net basis), that figure is still below the net-gross basis reported by the 2013 BIS survey for the likes of CAD (US$304bn), CHF (US$349bn), and AUD (US$584bn).

In addition, IMF also highlighted that the trading of RMB is more active in Asian timezone and then turns modest towards the end of European session and is "very low" between the close of European and opening of Asian session (i.e. during NY session).

Delayed, Not Derailed

While IMF staff notes that the international use of the RMB is rapidly becoming more common across a range of instruments and that the use and trading of the RMB has increased substantially since the 2010 review, it is not entirely satisfied that the RMB would fulfill the "freely usable" criterion due to data gaps as well as the lack of full analysis, which will provide additional input into the Executive Board's future assessment of whether the RMB is freely usable.

IMF staff says that given that the bulk of policy reforms to support RMB internationalization have occurred since 2010 and the authorities intend to implement further measures, it is likely that their full impact has not yet materialized and that these trends suggest that the growing international use and trading of the RMB is part of a durable trend especially with further reforms to liberalize onshore markets.

Overall this should mean that the latest developments from IMF merely delay, rather than derail, China's ambition to have the RMB included in the SDR. The policy paper also gives the Executive Board a reason to not make a decision at this year's review, which is consistent with our earlier contention that the RMB's probability of admission to SDR this year at 60%, which turns out to be 0%. For the 2016, we still think there is 60% chance for inclusion, given that the ultimate decision rests with "qualitative evaluation" by IMF's Executive Board and requiring 70% vote for approval, as pointed out repeatedly in the IMF policy paper. Until IMF makes the voting reform, the US holds the biggest block of votes at nearly 17%, Japan at 6.2%, Germany at 5.8%, among others, compared to China's share of 3.8%.

However, this is only a minor and temporary setback to China as we believe it will make policy adjustments and changes to address the issues raised by IMF, especially in the area of international access to onshore financial markets and instruments, as detailed in the policy paper (see links below).

From China's point of view, it is important to be included as part of the SDR reserve currencies, given China's economic size and the need to expand its influence in the global financial markets, as well as providing an alternative reserve currency to curtail the accumulation of US dollars in its own FX reserves. In addition, China is also using the SDR as a means to inject discipline and competition in its domestic financial markets, very much like what the admission to World Trade Organization (WTO) in 2001 did to China's competitiveness and economic development.

For now, we still see China maintaining a largely stable exchange rate (as IMF states that its priority is to maintain stability in the SDR value) into 2016, although we still think there is a chance of widening of trading bands this year from the current +/-2% range as well as potential for more FX volatility as see in early 2015. We maintain our USD/CNY forecast at 6.23 for end-3Q2015 and 6.20 for end-2015.

Source:
Review of the Method of the Valuation of the SDR —Initial Considerations, IMF, 3 Aug 2015
http://bit.ly/IMFsdr-initialval2015

Factsheet – Review of the Special Drawing Rights (SDR) Currency Basket, IMF, 4 Aug 2015
http://bit.ly/IMFSDR-factsheet2015

IMF Survey : IMF Work Progresses on 2015 SDR Basket Review, 4 Aug 2015
http://bit.ly/IMFSDR-QA2015

URL: www.uobgroup.com/research
Email: GlobalEcoMktResearch@uobgroup.com