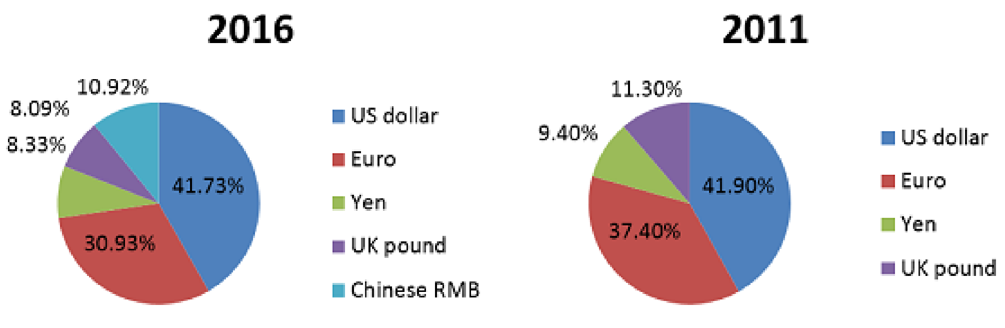
5 implications of the renminbi's ascension to the SDR basket

Dr Robert Gay | Fenwick Advisers | 08 December 2015

Now that the IMF's executive board has decided to add the Chinese renminbi to the fund's basket of reserve currencies, the Special Drawing Rights (SDR), speculation has already arisen about how the new status of the renminbi will affect everything from its foreign exchange value and China's economic performance, to the geopolitics of sanctions. Some implications are more predictable than others.

For example, many international financial institutions - including the IMF and about 70 central banks with portions of their balance sheets denominated in SDRs - assuredly will rebalance their holdings of RMB along the lines of the new currency weights of the basket (Figure 1). Multilateral institutions have about $600 billion in SDR-denominated assets, while member central banks have $280 billion. The RMB's weight of 10.92% in the SDR basket translates into about US$80 billion of assets that need to be shifted in renminbi when the new basket becomes effective on 1 October, 2016. While this amount is significant, official flows are not necessarily recurring and, as such, are not a likely source of a sustained currency appreciation over many years. Institutional investors would have to follow suit, not because they have to do so but rather because they find value in RMB-denominated assets.

Figure 1: Currency weightings in IMF SDR basket



Source: IMF

Conversely, just because the PBOC now permits greater flexibility in setting the foreign exchange value of the renminbi, a precondition for SDR status, it does not mean the currency will weaken either. Pundits seem to favor this view as the near-term outlook and the discount of the offshore renminbi relative to its onshore counterpart indicates that markets are expecting near-term depreciation. Granted, the one-off devaluation in August scared off a lot of carry traders and encouraged capital flight for other reasons. Beware, though, of extrapolating these short-term indicators into a long view on the renminbi. The big picture still favors secular appreciation because China is a net creditor nation that earns more hard currency than it owes abroad and has an ongoing current account surplus that bolsters its creditor status.

The question is what will happen in the interim, as China moves toward greater foreign access to domestic financial markets, notably fixed income assets, coupled with greater freedom for Chinese to invest abroad. In that regard, a key indicator for the currency will be whether or not the PBOC maintains positive real interest rates in a world where negative real rates still are the norm.

SDR status would seem to rule out at least two possibilities often bantered about in the debate on future flows.

For one thing, the PBOC cannot afford to 'engineer' a devaluation to bail out beleaguered manufacturers. Such a strategy would fall afoul of SDR tenets - namely, reserve currencies must be readily interchangeable at minimal cost and therefore must have transparent, market-based pricing for both interest and exchange rates. The PBOC has spent the past five years instituting of long list of reforms that underpin the basis for market-based pricing. Since the SDR announcement, PBOC officials have gone out of their way to stress that one-off devaluations are not on the agenda. A managed float with intervention bands is likely to continue as the policy framework for at least another five years. Capital controls, however porous and receding, still give the PBOC a measure of monetary control (which is the first priority) and the freedom to sell the RMB to maintain reasonable stability in the currency. The latter priority is essential to the nation's primary economic goals - namely, to rebalance the economy toward domestic-oriented demand and to encourage international use of securities denominated in RMB. In effect, SDR status marks an end of the old game plan of cheap labor and an undervalued currency and the onset of the new agenda of rebalancing growth.

For much the same reasons, financial reforms are likely to proceed apace. After all, the RMB still has shortcomings compared with the other elite currencies. Reforms alone do not guarantee a strong currency - rather, they are needed to augment the PBOC's toolbox as it strives to deepen local capital markets. For the past 25 years, the PBOC has relied on heavy-handed administrative tools to control credit and the money supply. Potent reserve requirements have been, and still are, the main tool of the country's monetary framework. No other framework, notably one dependent primarily on market-based pricing, would have sufficed during those early years of explosive growth and massive capital inflows. As reserves on deposit at the central bank have ballooned to exceed US$4 trillion, reserve requirements remain an indispensible monetary tool, for better or worse.

Circumstances have changed, however. Given the enormity of these readily spendable deposits, small changes in reserve requirements now run the risk of unleashing huge amounts of spending power. Moreover, the use of administrative directives in recent years to direct bank lending to targeted sectors has proven wasteful. Broader and deeper local debt markets would offer some hope of pricing credit risk more efficiently and more transparently than state banks currently do. Towards that end, the PBOC is experimenting with new interest rates to replace the old benchmark lending and deposit rates that were subject to ceilings and floors that now have been abolished. Although benchmarks will remain as a 'guide' for setting rates on loans and deposits, banks will have greater freedom without the regulated ceilings and floors. In particular, I expect local banks that lend to small businesses and households will offer deposit rates higher than the benchmark in the years ahead, without penalties being imposed by the PBOC.

In place of old administrative benchmarks, the PBOC is experimenting with several central bank rates as possible anchors to a new monetary framework. Think of these rates as something akin to the federal funds rate in the US – namely, policy rates set by the central bank as a reference for other rates. In this case, however, the PBOC hopes to establish a corridor of policy rates with the standing lending facility (SLF) rates as a ceiling on the cost of borrowing from the central bank, and to make that funding available on a broad basis, for whatever need, for the banking system. In the past, the SLF was used as emergency funding for liquidity during holidays, etc. A few weeks ago, the PBOC lowered the overnight SLF rate to 2.75% from 4.50% and the seven-day rate to 3.25% from 5.5%. The floor of the policy rate corridor probably will become the interest rate the PBOC pays on excess reserves which now stands at 0.72%, although the PBOC has not yet said so. The interbank repo rate at which banks lend reserves to each other is currently 1.81% – precisely the midpoint between the new SLF rate and that set for excess reserves, so the conceptual corridor for overnight policy rates is 0.72% to 2.75%. It will take time for these interest rate tools to become an established policy tool and, in the interim, the main barometer of the PBOC's policy stance and the most potent tool for managing liquidity will continue to be the reserve requirement on excess reserves.

Of equal significance, China has agreed to weekly auctions of three-month treasury bills and to make those auctions open to foreign bidders as part of the conditions for adding the RMB to the SDR basket. All the reserve currencies in the basket use the yield on a three-month sovereign security for pricing SDRs, and China clearly could not be an exception. I expect China will roll out auctions of longer maturities for foreign investors in the year ahead. In short, SDR status is likely to accelerate foreign access to China's debt markets, which should prove to be one of the most significant milestones in integrating China into the international financial system.

FINANCIAL REFORMS AS A PRE-CONDITION FOR CURRENCY APPRECIATION

Notwithstanding the IMF's penchant for open capital markets (which often has been misguided), China's acquiescence to the Fund's regimen of reforms has served its self-interest as well. As a net creditor nation vis-à-vis the rest of world, China needs an outlet for its excess savings. There simply are not enough profitable endeavors at home. If China wishes to invest its savings surplus abroad, it must balance those outflows with inward investments. Foreign firms already have exhausted many of the traditional opportunities in capital-intensive manufacturing industries, so inward flows must broaden to include financial instruments as well. In effect, this story is the flip side of the coin from what has happened over the past 25 years - massive foreign direct investment coupled with financial repression of domestic savers which made China into a creditor nation. Now, to maintain that status, it must facilitate the reverse - foreign access to Chinese securities in exchange for Chinese direct investments abroad. China's funding for the Asian Development Bank and Silk Road projects are sovereign manifestations of the need for foreign outlets. China's private savings are yet larger and will need to play a major role as well, just as Japan's savings glut moved abroad in the 1980s and 1990s.

The easiest way to visualise China's predicament is to recognise that the country's current account surpluses over the past 15 years, which sometimes reached 10% of GDP, by definition meant that domestic saving exceeded domestic investment. On balance, the country received more income from abroad than it spent and the difference has accumulated into a sizeable net credit with the rest of the world. A visible manifestation of that external surplus are the US$3.5 trillion in international reserves held by the central bank, in large part for further credit to private sector savers. As long as China maintains a current account surplus, pressure will build to invest abroad. To meet the needs of savers, China has only two options: firstly, to offer competitive returns on domestic financial assets (notably positive return yields on savings deposits); and, secondly, to facilitate balancing inflows from foreign investors into domestic financial assets. China will opt for some of both.

In the interim, the PBOC and authorities have clamped down on 'illegal' capital outflows, much of which was associated with phony invoicing of imports or exports. Hundreds of people have been arrested for transferring an estimated US$125 billion out of the country through bank accounts in southern China and Hong Kong. Cash transfers are restricted under China's capital controls. The presumption of most observers is that these controls will be relaxed as China moves toward market-based interest and exchange rates. The IMF does not require, however, the lifting of controls on outgoing money transfers as a pre-condition for SDR status. Nor do they meet China's definition of desirable foreign investments in income-producing assets that enhance the country's creditor status. What is necessary to meet the 'freely usable' criterion for the yuan is greater access by central banks and foreign investors to domestic bond markets - a development that is likely to gain momentum now that the RMB has gained reserve currency status. The flip side of that coin may be new guidelines on what constitutes 'legitimate' offshore investments.

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