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The IMF Confirms China's Yuan Inclusion In SDR Basket

At 10.92% Weight, Above JPY And GBP

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IMF staff earlier this month proposed that the yuan be added to the basket of currencies used to value the SDR, a reserve asset created by the institution in 1969, and today that decision is confirmed (as expected).

The IMF's Executive Board decision today means that the yuan will be included in the SDR basket from Oct. 1, 2016, effectively anointing the yuan as a major reserve currency and represents recognition that the yuan's status is rising along with China's place in global finance.

The IMF reviews the composition of the basket every five years. The fund rejected the yuan for inclusion during the last review, in 2010, saying the currency didn't meet the necessary criteria. But now…

- *IMF APPROVES ADDING YUAN TO RESERVE-CURRENCY BASKET
- *IMF SAYS YUAN TO JOIN SDR BASKET EFFECTIVE OCT. 1, 2016
- *IMF SAYS YUAN MEETS `FREELY USABLE' STANDARD
- *IMF STATEMENT DOESN'T SPECIFY WEIGHTING OF YUAN IN SDR BASKET
- *IMF SAYS CHINA IS EXPECTED TO HELP FACILITATE USE OF SDR
- *LAGARDE: ADDING YUAN RECOGNIZES CHINA'S PROGRESS ON REFORMS
- *LAGARDE SAYS CHINA TO IMPLEMENT MORE FINANCIAL REFORMS
- *IMF: YUAN TRADING UP SIGNIFICANTLY IN 2 OF 3 MAJOR TIME ZONES

Reuters then reports,

- CHINA'S RENMINBI TO HAVE WEIGHTING OF 10.92 PCT IN IMF'S BENCHMARK SDR CURRENCY BASKET

Which is less than the 14-16% expectation (but nationalistically greater than Japan's Yen and Britain's Pound)…

However, as politically-motivated as this decision may have been, now comes the hard part for China.

> The inclusion puts new pressure on Beijing to change everything from how it manages the yuan, also known as renminbi, to how it communicates with investors and the world. China's pledges to loosen its tight grip on the

currency's value and open its financial system will come under new scrutiny.

As The Wall Street Journal reports, *"The actual inclusion of the yuan in the SDR is a nonevent for most investors. The sound you'll hear is a collective yawn,"* said David Loevinger, a managing director at fund manager TCW in Los Angeles and a former U.S. Treasury official focusing on China. "The lack of data and policy transparency remains a risk for investors."

> While IMF inclusion is largely symbolic, it could open Beijing to criticism of its financial policieswhen the fund conducts its five-year review of the currencies in its basket. Formally, inclusion would add the yuan to the IMF's special drawing rights, or SDRs, a virtual currency IMF uses for emergency lending to its members and countries can use to bolster their reserves.
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> In the near term, inclusion would lead to a modest, less-than-$30 billion in new foreign demand for yuan-denominated assets, estimates Zhang Ming, a senior economist at the Chinese Academy of Social Sciences.
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> "Domestically, it's far from certain whether the SDR status could force other, structural overhauls," Mr. Zhang said.

It has been a long path…

But, as Bloomberg details, there are 4 critical points…

- SDR status doesn't require central banks to hold yuan but could be a catalyst for portfolio reallocation.
- Reserve managers for countries having strong trade and funding ties with China have the strongest incentive to increase yuan holdings.
- Reallocations by central banks may be gradual to minimize disadvantageous market pricing.
- Reallocations by private investors will be constrained until capital controls are lifted and transparency improves.

* * *

As we detailed earlier…
Note that there is already some notable divergences between actual reserve holdings and SDR weightings…

And Yuan's addition may increase downward pressure on the dollar…

> SDR weights since 1978 have been based on a country's relative share in reserve holdings by monetary authorities and the value of exports of goods and services. Preliminary estimates in August from the IMF put the yuan share of the SDR basket in a range between 14% and 16% depending on whether the yuan would be added as a fifth currency or replace an existing currency. Based on the latest available data, the euro appears likely to lose the largest ground in the IMF's new SDR basket.
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> The weights of the SDR basket create no formal obligation on the part of the

IMF's 188 members to hold a similar proportion of international reserves. Indeed, the IMF's Currency Composition of Official Foreign Exchange Reserves report — a confidential survey on the composition of central bank reserve holdings — indicates a preference, in aggregate, to hold a much larger share of the dollar and pound.

Suggested 15% weighting – which The IMF has not released yet

The reduction in dollar portfolio allocations from the IMF's recognition of the yuan as a reserve currency may prove larger over time than the change in the SDR basket would suggest. Dollar allocations may face greater downward pressure simply because they are so large relative to other currencies — more than three times the size of euro holdings, for example. Part of this disparity is valuation, a reflection that the dollar is trading at a 12-year high against the euro. The dollar has increased 21% in trade-weighted terms over the last five years, according to Bank for International Settlements' calculations of nominal effective exchange rates.

However, as Bloomberg concludes, the ability (and risks) are near-term constraints on any major re-allocations.

The willingness to hold more yuan and less dollars is one thing; the ability to execute is quite another. At the moment, the ability of private foreign investors to increase their yuan allocation is limited by China's capital controls. There are special arrangements for foreign central banks that give them enhanced access to China's foreign exchange and interbank bond markets.

Another hurdle for expanding yuan holdings is the perception of a lack of transparency and market manipulation by the Chinese authorities. Until access and perceptions change, these factors will slow the flow into the yuan. The depth and security of U.S. government bonds may also constrain switches out of dollar assets.

Central banks tend to adjust reserve allocations slowly, so as not to pit market pricing against them. This suggests a steady gradual stream of demand for yuan assets over time. Until portfolio rebalancing is complete, dollar rallies may be short-lived as these may be seen as attractive opportunities for investors in both the public and private domain to trim dollar exposure.

As finally, before everyone gets too excited – The history of yen internationalization offers a cautionary tale on hopes for the yuan.

Japan's experience suggests that a floating exchange rate, free cross-border flows and stable economic growth are all necessary for successful internationalization. The challenge for China will be hitting all three of those criteria.

Currency internationalization comes in three stages. The first is use in trade settlement and financial transactions. Second is providing a safe asset for investment by non-residents. Third is to serve as an anchor for the regional and — ultimately — global market. In the 1980s and 1990s, the yen made rapid progress from stage one to stage two. Since then, it has stalled and even started to retrace its steps in some respects.

Of course, Wall Street analysts are already getting excited, here are their initial reactions when The IMF hinted it was going to happen…

HSBC:

- SDR inclusion would encourage China to stick to much- needed financial and capital-account liberalization, Paul Mackel, HK-based head of global research, writes in note dated Nov. 14
- USD/CNH moved above 6.4000 on Friday, which could suggest that more flexibility on yuan is coming
- Market players will want to see more volatility in the currency eventually; hence, inclusion in SDR doesn't necessary mean that the RMB will be stronger
- Knee-jerk reaction for yuan to strengthen should be temporary; will be interesting to see if PBOC decides to become more hands-off

Commerzbank:

- China needs to show commitment to further opening up its capital account and accelerate domestic financial reforms, led by interest-rate liberalization, Zhou Hao, Singapore-based senior economist, writes in email
- Country needs to improve policy transparency to attract global investors; that would build trust between global investors and Chinese authorities
- PBOC should reduce frequency of intervention, allowing market forces to play a critical role
- China should provide more hedging options to corporates and financial institutions, so they can prepare for greater financial-market volatility

Huabao Trust:

- China stepped up rates liberalization in run-up to SDR inclusion; now it may increase pace of financial reform, Nie Wen, Shanghai-based economist, says in phone interview
- Onshore-offshore yuan spread is expected to narrow in coming days
- PBOC's monetary policy stance will still be the most important element for investors to gauge regarding the yuan's trading direction
- A more market-oriented system is crucial for Chinese capital markets; a "reasonable" pricing of domestic assets will reduce systemic risk

Maybank:

- Inclusion will largely be a symbolic move because slowing economy and capital-outflow pressures may delay FX reforms, Fiona Lim, senior FX analyst, says in phone interview
- SDR inclusion will improve "rationality" in investment and assets allocation, which will improve financial stability

SocGen:

- Any positive reaction on yuan's possible inclusion in IMF reserves to be short-term, given that the outcome was well priced in, says Jason Daw, head of Asia currency strategy at Societe Generale SA in Singapore.

- Being added to SDR unlikely to speed up the pace of reserve diversification into Chinese assets, Daw says in Nov. 14 e- mail interview
- “We continue to see an upward bias to USD/CNY over the coming months and expect it to reach 6.80 by mid-2016.”

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It would be most ironic, however, if China *achieves* its ultimate objective, which is simply to find foreign buyers for its currency as an offset to domestic outflows, which in turn sends the Yuan soaring beyond its pre-devaluation levels, thereby slamming the Chinese economy even further and assuring that the unfolding Chinese hard landing becomes a full-blown global crash.

Finally we could not help but see the irony in the fact that today The IMF accepts the Yuan into the ‘free market’ currency basket just a day after what appeared to be a huge intervention in the offshore Yuan market…