Economic Research

WEEKLY ANALYSIS

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IMF getting ready to give the yuan its first stripes

The IMF could add the yuan to Special Drawing Rights, creating a new reserve currency. Switzerland authorises direct yuan/Swiss franc trading. Higher demand for Chinese assets.

Key Points

- The IMF accepts the idea of adding the yuan to the SDR
- China strengthens measures to float the yuan
- IMF review and vote before the end of the year
- Criteria for adding a currency to the SDR
- Use of SDRs and boom since the 2008 financial crisis
- SDRs: an international reserve asset
- SDR yield and interest rate
- Allocations to IMF members
- SDR purchases and sales
- Yuan on an equal footing with the dollar, euro, yen and pound sterling
- IMF gives the yuan its first stripes
- Chinese financial market will benefit from this paragdigm shift
- Increase in value of assets in yuan in 2016

The IMF has accepted the idea of adding the yuan to the SDR

On 13th November, the Director General of the IMF Christine Lagarde announced that the yuan met all of the criteria required for it to join the highly exclusive club of countries whose currencies are used as a reference currency and included in the SDR (Special Drawing Rights).

As such, China could join the ranks of the United States, the Eurozone, the United Kingdom and Japan.

The yuan looks set to join the SDR currency basket (US dollar, euro, pound sterling, and yen), becoming a new international reference currency.

The yuan had already become an important currency for international trade, moving ahead of the euro in October 2013 to sit just behind the US dollar as one of the key currencies for international financial transactions. Since then, trade credits denominated in yuan have increased by around 30%.

According to SWIFT, in January 2015, the yuan became the 5th most used currency for global transactions, overtaking the Canadian and Australian dollars.

The number of banking institutions that carry out transactions in yuan increased tenfold between 2010 and 2015.

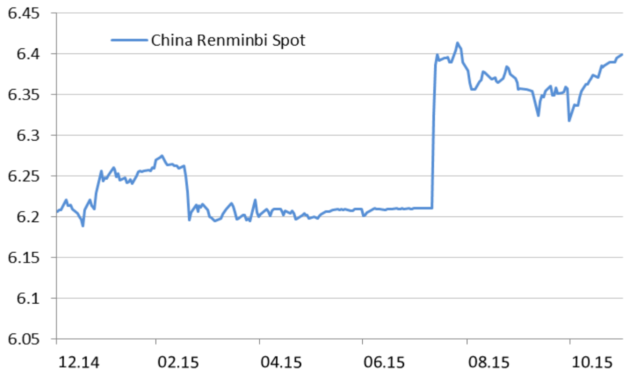
It is first and foremost China's economic strength and its foreign trade that have allowed the yuan to climb on international stock exchanges. In 2007, China moved ahead of the United States as the biggest global exporter, which boosted the yuan's rise.

Today, it is estimated that around 25% of all trading in China is already denominated in yuan. This figure should definitely increase over the next few years, and could well be given a helping hand by the newfound prestige that being added to the IMF's Special Drawing Rights will give the yuan.

In 2005, China had already changed tack, setting the yuan firmly on course towards internationalisation, by modifying the way in which the exchange rate with the US dollar was set. Since then, the yuan has gradually appreciated within the fluctuation limits set by the People's Bank of China. This was initially capped at ±0.3%, and then ±2% in 2014. The yuan appreciated 23% against the dollar from 2005 to 2015, with the exchange rate changing from 8.28 yuan to the dollar to 6.38 yuan.

Over the summer, financial markets were particularly affected by the -1.9% depreciation of the yuan against the dollar in August.

Yuan



Sources: Bloomberg, BBGI Group SA

China strengthens measures to float the yuan in the near future

The People's Bank of China (PBOC) had indicated that it was using a new method to calculate its reference rate and in doing so wished to give the value of its currency a larger share of the market. It had already taken another step forward, announcing that it would now take into account supply and demand on the currency markets and the values of other currencies to a greater degree in order to more accurately calculate the real value of the yuan.

Investors, with the United States leading the charge, undoubtedly preferred to believe that the change in the exchange rate reflected economic difficulties and the government's desire to boost the Chinese economy's competitivity. They have often criticised China for artificially devaluing its currency.

On the contrary, for its part, a few months ago the IMF announced that the yuan was likely no longer undervalued, in contrast with the United States' position in its analysis of the situation.

In light of the most recent developments, it would perhaps seem that China has wanted to show its desire to gradually move towards a floating exchange rate system. China thus presented the IMF with another token of their good faith so that it would accept China's request to join the SDR reference currencies.

Although the volume of transactions in yuan has not stopped growing, for the time being, free conversion of the currency is not guaranteed. Foreign nationals are still not allowed holdings in yuan, just as Chinese nationals are still not allowed holdings in other currencies.

Indeed, conversion of the yuan is still subject to certain conditions, but the Chinese authorities are putting in place their strategy, gradually liberalising yuan conversions. We should see an increase in incentives that facilitate participation in the RQFII Scheme (Renminbi Qualified Foreign Institutional Investors). Equally, the system in place since 2014 allowing investors to buy and sell mainland Chinese assets via the Hong Kong financial markets should be expanded.

The Chinese authorities are also working on other projects aiming to facilitate floating the yuan in the longer term. China is considering putting in place an insurance system for savers' deposits. In cases of insolvency, there would be similar compensation to that of developed countries, guaranteeing savings deposits up to a value of CHF 100,000 in the case of bankruptcy, for example. This measure should provide more flexibility in setting interest rates and deposit interest rates.

IMF five-year review, with a vote before 30th November

Recently, the IMF has given to understand that the Chinese yuan could be added to the basket of currencies and official currency reserves set out and issued by the institution in the form of SDRs (Special Drawing Rights).

Christine Lagarde has indicated that the yuan could very soon be included in the SDR, but has declined to give a likely date. A vote could be held as soon as 30th November as to whether to include the yuan in the SDR from 2016 onwards.

The US position is clear. The American authorities will undoubtedly oppose any change which could threaten the dominance of the US dollar. However, although the United States' voice carries great weight at the IMF, adding a new currency to the SDR only requires a 70% majority, unlike other decisions that require 85% of IMF members to give the green light. The United States cannot therefore block this decision, as they represent only 17.69% of the vote, and so cannot alone prevent the vote from going through. They would need to get other member states on side in order to block the process. Five years has brought about quite a shift in paradigm. In 2010, on the 41st anniversary of the SDR, IMF officials did not look favourably upon the possibility of adding the yuan, mainly because of capital controls, but also because of the small number of transactions denominated in yuan, as well as the under-valuation of the currency. However, despite considerable changes in the role that emerging countries have played in the make-up of international trade and monetary reserves over the last few decades, the composition of the SDR has not changed. As such, the dollar continues to represent 42% of the currency basket, followed by the euro at 37.4%, the pound sterling at 11.3% and finally the yen with 9.4%.

Criteria for adding a currency to the IMF's SDR

The criteria for adding a new currency were last revised in 2000. They state that the SDR is comprised of the currencies of countries (or monetary zone in the case of the euro) whose exports of goods and services had the largest value over a five-year period, and which have been determined by the IMF to be "freely usable". This first criterion regarding exports aims to ensure that the currency in question is a key player in international trade. According to the Articles of Agreement, a currency which is widely used to settle international transactions and frequently traded on the main currency markets is considered to be "freely usable". This definition has the advantage of being relatively flexible as it does not require the currency to be 100% convertible at all times or to be floated. As such, restrictions on capital do not represent an obstacle to the yuan joining the SDR.

As it currently stands, the yuan meets the criteria relating to exports and the currency being freely usable that are required to join the SDR, without the currency being freely convertible at all times.

At a later stage, IMF discussions should focus on the methodology used to establish the weightings of the currencies in the basket, and the instruments used to estimate the SDR interest rate. The IMF Executive Board will therefore soon consider including the yuan. Without trying to predict the final decision, suffice to say that the review already seems to be well underway.

Initial use of the SDR and its boom during the financial crisis

The SDR was created in 1969 to support the fixed exchange rate system. Before the collapse of the Bretton Woods system, all countries had official reserves made up of gold and reference currencies traded on currency markets to determine their exchange rate. With the development of international trade and the financial system, the reserves of gold and US dollars available proved insufficient. With the IMF as mediator, the international community created a new reserve instrument called the SDR. When the fixed rate exchange system was replacd by the floating exchange rate system, the SDR's role became less important as the rise of financial markets and new finance instruments facilitated access to capital. However, since the 2008 financial crisis, the SDR has come back front and centre stage. To date, nearly 200 billion SDRs have been allocated to top up the official reserves of some member states, and to support the finance needs of countries that were wrongfooted by the financial crisis, for example. Issues with the supply of liquidity in the international economic system were thus able to be resolved.

The SDR is not a currency, but an international reserve asset

At the outset, the value of the SDR was set at 0.888671 grams of fine gold, which was equal to 1 US dollar. When the Bretton Woods system collapsed in 1973, the SDRs were indexed based on the value of a currency basket. Since then, the composition of SDRs has been based on a reference currency basket, which is currently made up of the US dollar, the euro, the yen and the pound sterling. The IMF Executive Board reviews the composition of the reference currency basket every five years. At this time, the door is open for other currencies to join this exclusive club. In 2010, the weightings were revised based on the value of goods and services exports, and the levels of reserves denominated in each of the currencies held by the other members of the IMF. The daily value changes each day and is posted on the IMF's website. SDRs can be exchanged for freely usable currencies.

SDR interest rate

The SDR interest rate is used to calculate loans to member states and the interest on SDR holdings that the IMF pays member states. The SDR interest rate is set based on a weighted average of the representative interest rates on short-term debt instruments in the money market of the SDR basket currencies.

SDR allocations to member states

In virtue of its Articles of Agreement (Article XV, section 1, and Article XVIII), the IMF can allocate SDRs to member states as a percentage of their respective quotas. These allocations give each member state a costless and unconditional international reserve asset. General SDR allocations must seek to meet a long-term global need to supplement existing reserve assets. The decision to carry out a general SDR allocation is taken for periods of up to five years, although to date there have only been three general allocations. The first (a total of 9.3 billion SDRs) was issued in 1970-1972; the second (12.1 billion SDRs) was issued in 1979-1981; and the third (161.2 billion SDRs) was issued on 28th August 2009. The general and special allocations in 2009 brought the cumulative total of SDRs to 204 billion.

Purchase and sale of SDRs

Members must often purchase SDRs in order to settle their obligations to the IMF, or can decide to sell SDRs in order to change the composition of their reserves. The IMF functions as an intermediary between members and prescribed holders to ensure that SDRs can be exchanged for freely usable currencies. Following the allocation of SDRs in 2009, the number and scope of voluntary agreements increased in order to maintain liquidity levels on the voluntary SDR market. There are now 32 voluntary trade agreements, including 19 new agreements since the SDR allocations in 2009.

The yuan has earned its first stripes, having been pulled up the ranks by the IMF

Adding the yuan to the SDR would have a primary fundamental effect on China's image. It would enter the exclusive club of reference and reserve currencies via the front door.

China's prestige will immediately take a leap, but, above all, it will demonstrate that the yuan is safer and more robust than many observers consider it to be. By standing on an equal footing with the US dollar, the euro, the yen and the pound sterling, from 2016, the yuan would impose itself as a trusted reserve currency. From 2016 on, central banks will buy more yuan and investors will be more willing to turn to Chinese assets, which will then be more accessible and considered to be less risky. We should therefore see Chinese financial markets (equities, bonds, etc.) opening up to foreign investors to a greater degree, as well as gradual normalisation of holdings of Chinese assets in internationally diversified portfolios.

Direct conversion between Swiss franc and the yuan

The Swiss National Bank (SNB) has recently confirmed that it will launch a direct yuan/Swiss franc exchange rate on the official Chinese Foreign Exchange Trading System (CFETS). "Direct trading will facilitate and promote the use of the [yuan] in cross-border transactions between businesses and financial institutions". The two currencies will be able to be directly converted without going through the US dollar.

Conclusion

The IMF is getting ready to give the yuan its first stripes.

The Chinese yuan should become a reference currency and an international reserve currency from 2016 onwards.

This marks a paradigm shift for the yuan and Chinese assets, which are now considered more robust.

Chinese financial markets will be more open to international investors.

Holdings of assets denominated in yuan will gradually be normalised.

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