RMB TO BE INCLUDED IN SDR

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As Haiyan Li has highlighted since few quarters, the IMF board voted on November 30th to include the Chinese RMB in the currency basket of its Special Drawing Rights (SDR). The RMB thus becomes the 5th currency in the SDR basket alongside the USD, the EUR, the GBP and the JPY.

This is a long term positive for China. Even being rather a symbolic event, it nevertheless marks the progress in the RMB's internationalisation and the SDR recognition should increase international acceptance of the RMB and facilitate its rise as a reserve currency.

The Chinese authorities have been opening up the country's financial market over the last two years and they need to attract more international institutional investors.

The positive outcome will of course depend on the ongoing financial reforms, the capital account opening and the RMB internationalisation.

We are not expecting major moves either from the currency or the equity market in the short term following the IMF decision, although the long-term impact should not be underestimated. The new basket will come into effect October 1st, 2016.

What does it change?

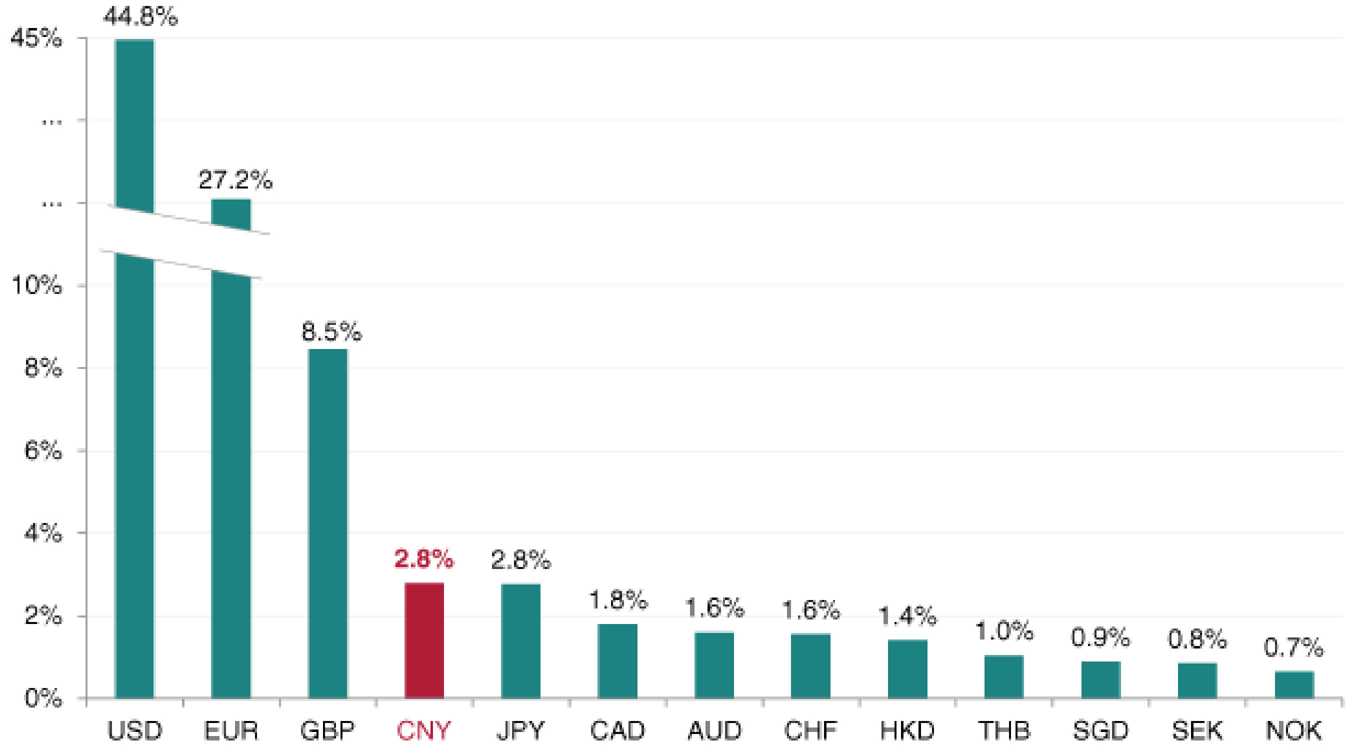
The SDR inclusion will have no immediate impact or benefit. Joining the SDR does not automatically trigger significant RMB purchases by IMF members. But this official recognition should lead over the mid/long-term to a gradual increase of RMB denominated holdings by governments and private asset managers.

This step marks an irreversible step in China's financial liberalisation, and the government should continue to use the SDR inclusion as a catalyst to deepen financial market reforms including a more flexible exchange rate regime and a more open capital account.

The 13th five year plan shows that the government aims to "orderly proceed towards capital account convertibility" in the next five years, with measures including the opening of capital markets, a gradual removal of quota restrictions on QFII, RQFII and QDII, expanding foreign institutions' participation in domestic interbank bond market, a reduction of restrictions on RMB fund raising by foreign institutions, relaxing foreign exchange restrictions for corporates and households, and a push to increase the role of the RMB in cross-border payments and international reserves.

To accompany this internationalization, China is developing its own international payment system, the CIPS (China International Payments System), to compete with American transfer system SWIFT. Through the CIPS, Chinese banks and international banks will be able to trade directly in RMB without intermediaries.

China represents approximately 15% of international trade, while nearly 3% of transaction volumes are in RMB. However the RMB was already the 4th most widely used transaction currency worldwide (Source: SWIFT, Sept 2015):



Source: International Monetary Fund, 02/12/2015

The most direct impact will be on China's bond market. Over the short term, the expected US rate increase, concerns on further RMB depreciation and an increasing number of onshore credit events will continue to weigh on markets.

However, over the longer term, China's onshore bond market should benefit from increased global portfolio allocation flows as China opens further its domestic markets.

Thanks to the IMF's decision, China will be able to issue sovereign, local government and corporate debt denominated in RMB to international investors more easily. Chinese companies - including state-owned enterprises - can now raise financing in RMB on international markets compared to limited size in the past.

Foreign investors' share of onshore capital markets is small, at only around 2% of onshore equity markets and even less for onshore bond assets. As of today, central banks globally hold currency reserves totalling some USD 12 trillion. With a 10.92% weight in the SDR, we would be talking about a potential reserve demand for the Chinese currency of USD 1.2 trillion in the long run.

Global bond indices could also increasingly include Chinese bonds for index tracking investors. Policy should continue evolving to support these trends. This July, for instance, the PBoC eliminated all preapproval requirements and quotas for foreign central banks, sovereign wealth funds and global financial organizations to access China's interbank bond market. Of course other aspects will be important as well, such as the liquidity of the domestic bond market and the volatility of the exchange rate.

RMB's inclusion in SDR will also not have an immediate impact on FX inflows (i.e. a strengthening of the RMB), neither lead to a RMB depreciation. As outlined above, any increase in foreign central banks' demand for RMB assets will likely be gradual.

We expect a modest depreciation relative to the dollar before October 2016. We consider that interest rates will continue their downward trend in China, while the Federal Reserve increases rates in the US

On the other hand, we expect RMB denominated assets to progressively become a crucial part of global fund portfolios, and therefore expect a steady growth of inflows entering China's onshore capital markets, especially as outstanding inflow restrictions continue to be step by step lifted in the final stage of China's capital account opening.

There will be no direct impact on equity markets neither, as investors will not change their allocation to Chinese equities following the SDR inclusion. Equities are of course a main beneficiary of the long term benefits of the ongoing reforms and financial markets opening, for which the IMF decision is an encouraging symbol.

What is the SDR basket?

The Special Drawing Rights (SDRs) is an international reserve asset, created by the IMF to supplement the existing official reserves of member countries. In addition to its role as a supplementary reserve asset, the SDR serves as the unit of account of the IMF and some other international organizations.

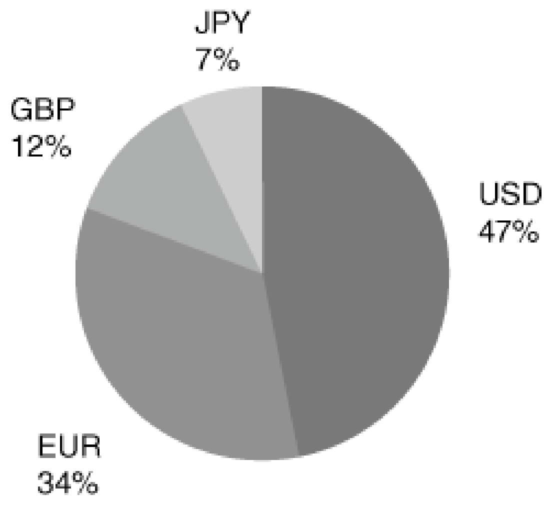
The SDR is neither a currency, nor a claim on the IMF. Members can hold SDRs as part of their international reserves. Members can exchange SDRs for freely usable currencies among themselves and with prescribed holders; such exchange can take place under a voluntary arrangement or under de signation by the IMF.

Members can also use SDRs in operations and transactions involving the IMF, such as the payment of interest on and repayment of loans, or payment for future quota increases.

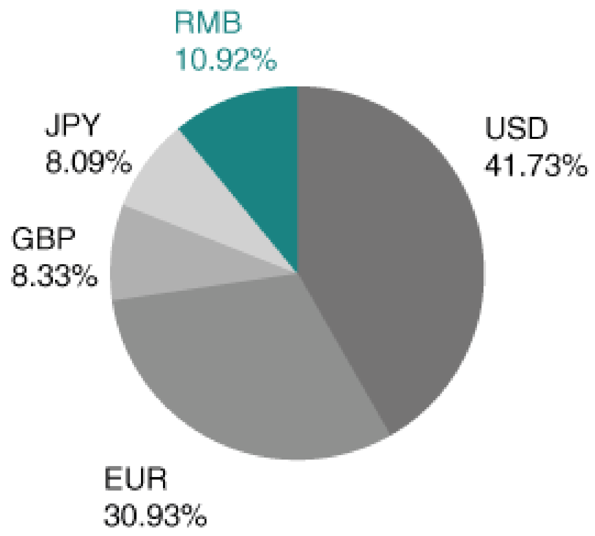
The RMB inclusion will generate a small direct demand of RMB assets from the Bank for International Settlements (BIS), as some central banks place deposits at the BIS, which in turn manages these assets by matching the constituent currencies with the SDR.

The RMB becomes the first currency added in the post-Bretton Woods era and it is the first SDR currency from a developing country. The basket is reviewed and adjusted every five years.

Current components of the IMF's SDR



New components of the IMF's SDR



Source: International Monetary Fund, 02/12/2015

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