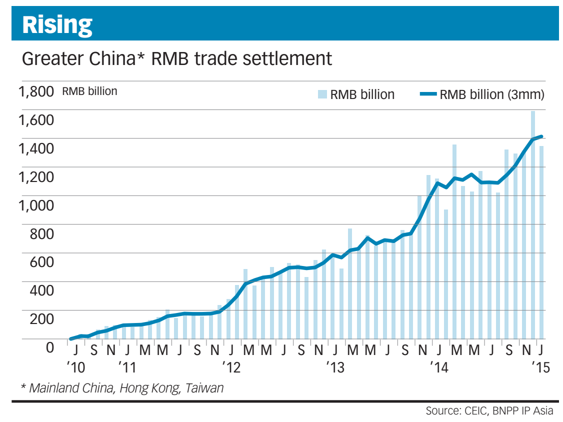
MONEY MATTERS

Can RMB become SDR component currency?

The renminbi may not yet qualify to be included in the IMF's Special Drawing Rights but the game may change in Beijing's favour. BY CHI LO



THE discussion about including the renminbi in the International Monetary Fund's (IMF) Special Drawing Rights (SDR) is not new. People's Bank of China governor Zhou Xiaochuan first raised the question on the SDR components when he suggested in March 2010, at a G20 meeting in London, to replace the US dollar by the SDR as the world's reserve currency.

The talk has gained momentum recently, as the IMF is going to review the components of the SDR basket in November this year.

At a press conference on March 12 during the National People's Congress this year, People's Bank of China deputy governor Yi Gang revived the idea of including the renminbi in the IMF's SDR basket.

SDR – a fast track for the renminbi?

The SDR may be a fast track for the renminbi to elevate its reserve currency status. Currently, the SDR includes four reserve currencies: the US dollar, euro, pound sterling and Japanese yen. There has been speculation that when the IMF reassesses the weightings of these currencies in November, it may add new currencies such as the renminbi to the currency basket.

Contrary to market hype, the direct global effect of including the renminbi in the SDR will not be significant in the short-term, as the SDR accounts for about 5 per cent of global official reserve asset holdings. Currently, total SDR is equivalent to about US$310 billion, with the US dollar, euro, pound sterling and Japanese yen accounting for 42 per cent, 37 per cent, 11 per cent and 10 per cent, respectively, in the SDR basket.

If the renminbi were to be included in the SDR, it is unlikely that it would command a share larger than the pound sterling or the Japanese yen. So even if it were assigned a 10 per cent share, central banks' demand for renminbi via the SDR would amount to US$31 billion only, which is negligible in global terms. After all, the SDR is not a currency, so adding the renminbi to the SDR basket will not have any material impact on international trade and financial transactions.

Technical versus practical considerations

Technically, the renminbi cannot be an SDR component by the IMF's Balance of Payments definition of a "freely usable currency". The current four SDR currencies are issued by IMF members (or monetary unions that include IMF members), are the largest exporters in the world, and have been determined by the IMF as freely usable. The latter was added as a formal criterion in 2000 and is open to interpretation, as is the number of component currencies. However, the notion that a freely usable currency ought to qualify for the SDR basket has been intensely debated.

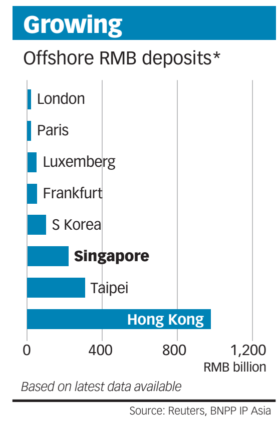
First, it does not strictly mean full currency convertibility. Second, the renminbi has already met some of the conditions for a freely useable currency; notably it has been fully convertible on a current account basis since 1999, and is being increasingly used in international trade settlement and in the denomination of offshore deposit accounts since 2009. According to official data, renminbi trade settlement accounted for almost 20 per cent of all China's foreign trade in 2014, up from less than 1 per cent in 2009.

Meanwhile, offshore renminbi deposits have grown from virtually zero in 2004 to about 10 per cent of total bank deposits in Hong Kong. They have also been accumulated in other centres, such as London, Singapore, South Korea, Taipei and continental Europe, though in smaller amounts.

The People's Bank of China has also signed 25 currency (renminbi) swap agreements with foreign central banks, with the number of agreements expected to increase over time. Lastly, the Renminbi Global Index, which has been developed by a global bank and SWIFT and measures the overall growth in offshore renminbi trade and financial transactions, has reached record highs since its inception in December 2010.

IMF's stance

The IMF has kept its flexible stance on SDR component currencies, knowing that the decision of including a currency such as the renminbi in the SDR basket is ultimately political. In November 2011, it proposed four indicators for assessing a currency's potential for inclusion in the SDR. These are trading volume of that currency in spot FX markets; trading volume of its derivative instruments in the FX and over-the-counter markets; market-based interest rate pricing mechanism; and currency composition of official FX reserve holdings. However, it has not specified any benchmarks for these indicators, thus leaving the final decision of inclusion to the politicians.



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China has likely fulfilled the first condition, and is working on the second one. Interest rate liberalisation is still an obstacle, given China's slow pace on this development. It is moving ahead nevertheless, with incremental interest rate liberalisation steps since July 2012, including scrapping all bank lending interest rate caps and increasing the deposit rate cap to 30 basis points above the official benchmark rate (from 20 basis points). If the renminbi becomes the third major reserve currency, as we are expecting, in the next few years, the fourth criterion would be met. In a nutshell, the IMF has left itself considerable room to manoeuvre depending on the change in political winds.

Ultimate question

The ultimate question is who decides the issuance and the pricing of the SDR – the IMF? Asia and many other emerging market economies will almost certainly object to that, given the track record of the IMF's economic prescriptions causing their economies hardship. China may not want to empower the IMF either. That is why in the April 2009 G20 summit in London when Russia proposed an IMF/G20 Working Group to assess the idea of a global reserve currency, there was no input from China at all.

In a nutshell, there is no credible successor to the US dollar as a super global reserve currency in the medium term. No other economies or financial markets are large and deep enough to replace the US as a safe haven during crisis periods. The euro, or even the renminbi, may become an alternative down the road, but that is a long way away.

Long-term impact

Even the prospect of the renminbi becoming an SDR component currency with an increasing weight might create a virtuous cycle where anticipation of deeper renminbi internationalisation (stemming from being an SDR component) would prompt more central banks to hold the renminbi, which would then actually deepen its internationalisation and prompt more central banks to hold more of it. The cycle could snowball and increase the weighting of the renminbi in global reserve allocations to challenge the pound sterling, Japanese yen and the Swiss franc, each currently has not more than 4 per cent of the global reserve allocation.

Global equity and bond indices will also include renminbi assets in their components, so international asset managers will have to include renminbi assets in their portfolios. All this will, in turn, facilitate renminbi international payments for trade and financial purposes. Since major structural changes are needed to fully internationalise the renminbi, the ultimate goal is to use it as a means (an external force) to achieve structural reform success, the end goal of China's liberalisation process.

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FUND MANAGER'S TAKE

Asia gains from low oil prices

NN Investment Partners favours Asia over other emerging markets. BY JOEP HUNTJENS

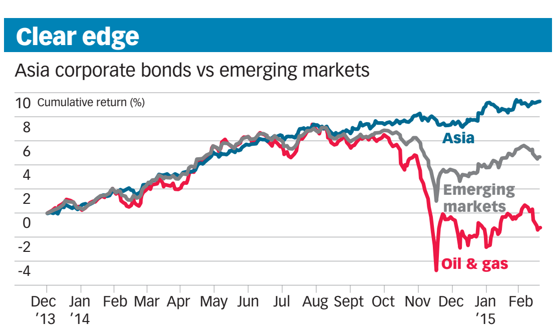
AFTER five years of coping with oil prices that hovered between US$100 and US$120, prices tumbled in June 2014. Since then, the price of Brent crude oil – the global benchmark – has fallen 50 per cent to about US$55 as at the end of March this year. That drop is partly because of weak economic activity but most of it appears to be caused by the growing glut of supply, particularly from the US.

Investors have reacted accordingly by shunning emerging markets, where many countries are oil exporters. The JPMorgan Corporate Emerging Markets Bond Index, which tracks US-dollar denominated bonds issued by companies in emerging countries, has underperformed developed markets. The oil and gas sub-sector has recorded a -5 per cent return since July 2014. Equity markets have also felt the pain, with the MSCI Emerging Markets Index declining 10 per cent.

But the rout masks the divergence between different emerging markets. Many Latin American economies are vulnerable because they are net oil exporters. Some of them have relied on high oil prices to mask mismanagement and to pay for costly foreign adventures. In Venezuela, oil accounts for more than 95 per cent of its export revenues, which help fund heavy welfare spending. Inflation is well above 60 per cent.

In Europe, Russia is in the middle of a currency crisis. The rouble has tumbled to historical lows in line with falling oil prices. This has made imports more expensive, causing inflation to quicken to 16.7 per cent year-on-year in February. Russian companies, which have already been cut off from international capital markets because of Western sanctions, are finding it increasingly difficult to fund debt repayments denominated in foreign currencies. Moscow reckons that GDP could fall by 3 per cent in 2015.

But Asia marches to a different beat. With the exception of Malaysia, Asia is a net oil importer with oil accounting for 15-20 per cent of total imports in the region. This means that as energy prices fall, the disposable income of consumers and businesses increase due to cheaper costs for transportation and electricity. This is particularly crucial for China because it is the world's second-largest importer of oil.



Meanwhile, cheaper energy moderates inflation. In the past three months, this has allowed central banks in Singapore, Korea, China and India to ease interest rates, even as a recovering US looks to do the reverse. This is a boon for many countries, which can maintain accommodative policies to counter slowing growth.

Finally, cheaper oil improves the current account balance. India and Indonesia have taken advantage of the drop in oil prices to cut poorly-targeted fuel subsidies. According to India's oil ministry, every dollar drop in oil prices helps reduce the government's subsidy burden by US$1 billion, which in turn trims the current account deficit.

Attractive investment opportunities

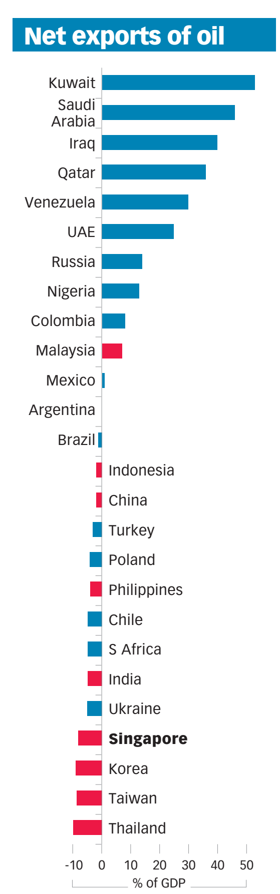
Within the oil sector, I prefer investment-grade companies to their high-yield counterparts. Investment-grade companies have strong balance sheets and adequate liquidity, which make them better placed to weather falling oil prices. Many are also backed by the state and would not be allowed to fail.

In Asia, I am most optimistic about India's prospects. The impact of falling oil prices is positive for its macroeconomic story and the IMF is forecasting that the country's growth will accelerate to 6.4 per cent this year from an estimated 5.6 per cent in 2014.

Within India's oil industry, I favour quasi-sovereigns. State-linked oil producers and refiners fulfil a national service role by partially subsiding lower oil prices to the end consumer. For producers, this means that they sell oil to refiners at government-set prices, which hurt their earnings margin. For refiners, they sell oil to retailers at a loss and are only reimbursed by the government at a later stage. With lower oil prices, producers now have a profit cushion because of their low cost of production, while refiners become less dependent on government subsidies.

I am more cautious of Malaysia. The country is one of Asia's largest producers of petroleum-based products, garnering about 30 per cent of its fiscal revenue from sales of oil and liquefied natural gas. The 50 per cent fall in oil prices has triggered a cut in the official 2015 growth forecast to 4.5-5.5 per cent from 5-6 per cent previously.

I am underweight on oilfield services and equipment makers. These companies would see fewer orders from upstream companies, which are scaling back on capital expenditure. In China, this is exacerbated by the government's reform and anti-corruption drive, which might make state-backed oil producers less keen to outsource to independent third-party service providers.



What will the oil price be in a year's time? Nobody knows. But low prices look like they might be here to stay. The Organization of Petroleum Exporting Countries has made no attempt to bolster prices and America's shale oil is a genuine rival to conventional oil. As the economics of oil continue to change and the industry morphs and consolidates, there is no better chance to look for attractive investment opportunities.

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