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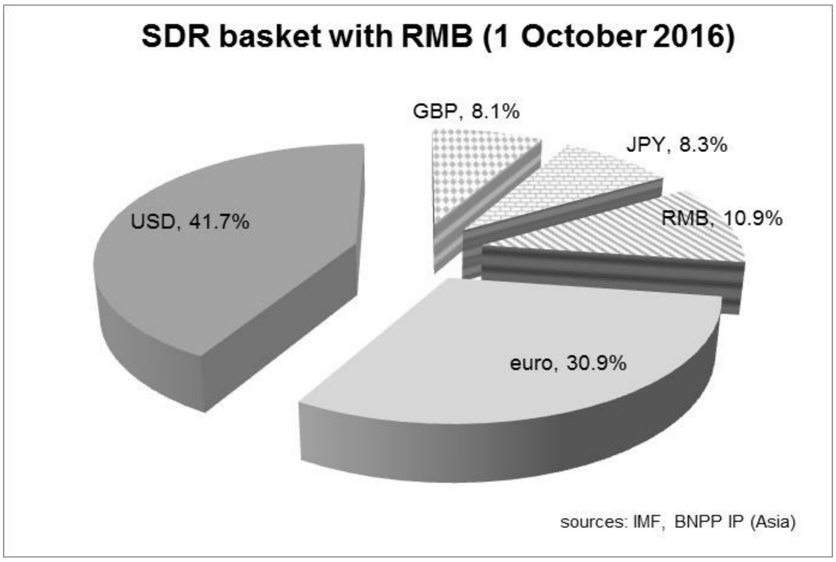
RENMINBI GOING INTO THE SDR BASKET

It always seems impossible until it's done.

Nelson Mandela

The renminbi will join the International Monetary Fund's (IMF) Special Drawing Rights (SDR) basket this Saturday, 1 October, which is also China's National Day. So the day will be double-happiness for China.

For the world, the renminbi's entry to the SDR basket seems to be much to do about nothing, with only a symbolic impact on both the global and Chinese economy. Even with the third largest weighting (10.92%) in the basket, just behind the USD's 41.73% and the euro's 30.93% (see chart), the renminbi remains an indirect, and a tiny, part (0.27%) of global reserves.



As we argued recently (see "*Chi Time: The Renminbi in Special Drawing Rights, What's Next?"* 25 November 2015), additional central bank demand for renminbi to benchmark their reserve portfolios to the SDR basket weightings is small. There are about 204 billion SDRs outstanding, equivalent to about USD285 billion, compared with USD11.6 trillion of global reserves[1]. Assuming global central banks will increase their aggregate holding of renminbi to match its 10.92% weighting in the SDR basket, additional demand for the Chinese yuan will amount to USD31 billion, which is a drop in the ocean of global liquidity.

After all, global central banks have had a year, since the IMF's Board decision last November on including the renminbi, to adjust their portfolios to accommodate the renminbi in the SDR basket. This means that the bulk of central bank buying renminbi should have happened already. But these central bank inflows have hardly made a dent in China's financial account, which is still bleeding red, although capital outflows have slowed down sharply (see table).

China's net capital account flows (USD bn)

		2015	1Q2016
Direct investment		62.0	-16.0
Portfolio investment		-66.0	-41.0
Derivatives		-2.0	1.0
Other investments		-479.0	-67.0
Errors & omissions		-188.0	-39.0
Total net flows		**-673.0**	**-162.0**
sources: CEIC, BNPP IP (Asia)			

SDR inclusion of the renminbi is not relevant to the portfolio rebalancing decision (to increase the weighting of renminbi-denominated assets) of international investors. The impact on global portfolio decisions will come from foreign investors' assessment of China's fundamental outlook, the opening of China's capital account and the decision by international index providers, such as MSCI, to include Chinese A-shares in their global indices.

From a reform perspective, the renminbi's SDR status confirms the recognition by the international community of China's economic ascendency and structural reform efforts. This should act as an external force and a confidence booster for China to push for more reforms. However, it seems that this strategic importance has faded as Beijing has downgraded the priority of structural reforms since the IMF Board decision last year in exchange for upgrading GDP growth as the top policy priority.

In other words, Beijing seems to have taken the attainment of the SDR status as a sign that its role as a force to push structural reforms has been completed. So the collateral benefit of being a SDR currency to China's reform process has greatly diminished.

[1] This implies that the amount of SDR is about 2.5% of global reserves.

This attitude raises the risk of reform complacency. But this does not necessarily mean that China's structural reforms will stall post-SDR entry. New reform efforts, such as the expansion of the renminbi offshore market and further opening up of the onshore capital market by expanding the investment quotas and stock connect schemes, will likely proceed faster than other deep-rooted changes, such as SOE and banking reforms.

Finally, the SDR status will facilitate China's effort to internationalise the renminbi. So it will be more widely-used in international payments going forward. But until some major tasks of structural reforms are done to improve the domestic system, the renminbi will remain a thinly-used reserve currency.

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