Economic Analysis

China | SDR inclusion cannot reverse the depreciating trend of the RMB exchange rate

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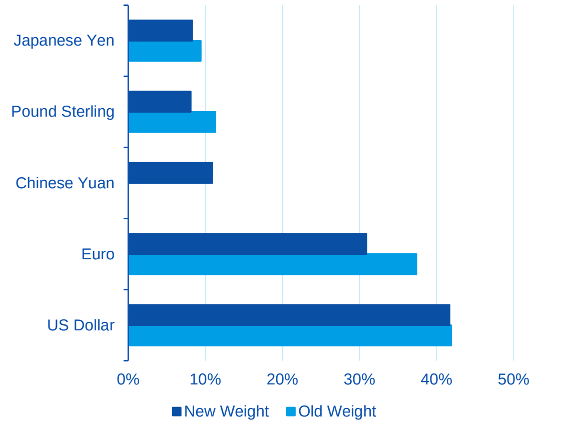
On November 30, the International Monetary Fund (IMF) announced the long-awaited decision to include the RMB in the basket of currencies that underpins special drawing rights (SDR). In the new basket, the RMB was given a weight of 10.9%, in third place after the US dollar and the Euro, but ahead of the British Pound and the Japanese Yen (Figure 1). The inclusion of the RMB will take effect starting from October 2016, leaving ample time for member states to adjust their foreign reserve portfolios.

Undoubtedly, the IMF's decision marks an important moment in China's long journey to achieve the internationalization of its currency. However, just like the SDR itself, the decision to allow the RMB into the basket is predominantly symbolic. It is estimated that the SDR accounts for merely 2.5% of the global reserves assets, which currently exceed USD 10 trillion. However, SDR inclusion will not be effective in reversing the depreciating trend of the RMB since August, given strong headwinds from persistent economic slowdown, accelerating capital flows and the impending US interest rate lift-off. We maintain our projections at around 6.45 CNY/USD by the end of 2015 and 6.8 CNY/USD by the end of 2016.

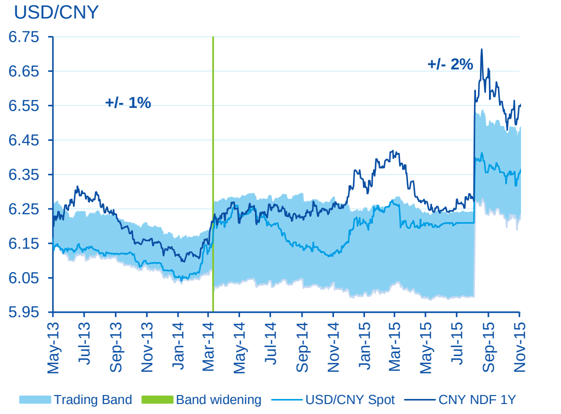
- **Two factors limit the impact that SDR inclusion will have on boosting the use of the RMB as a global reserve asset.** First of all, the existing restrictions under China's capital account have prevented other central banks and governments from holding more RMB assets in the past. In other words, as long as China's capital account is not fully liberalized, other central banks will be unwilling to hold RMB assets, regardless of SDR inclusion. After all, a central bank's foreign reserves need to be highly liquid so that they can be easily sold on the market in an emergency. Second, China has already signed a large number of bilateral swap agreements with other central banks, which, to some degree, reduces the real demand for these central banks to hold RMB assets as part of their foreign reserves.
- **On the positive side, SDR inclusion has made China's financial liberalization agenda increasingly irreversible.** Inclusion into the basket of currencies that underpins SDR will become effective starting from October 2016. This means that the authorities need to continue to fulfill their commitments to the IMF and make the RMB more "freely usable". Indeed, it not only concerns the opening of the capital account but also involves a large number of coordinating reforms in the domestic financial system and the exchange rate regime.
- **The exchange rate depreciation is set to continue for next year.** After the SDR inclusion, we expect the authorities' focus to shift towards increasing the flexibility of the exchange rate, since this is regarded as an important premise for further capital account liberalization. We reckon that the August devaluation of the RMB is indeed a failed attempt in this respect. The depreciation of the Yuan is therefore "unfinished business"; so it is likely that the authorities will continue to pursue this agenda at different moment in the coming months – we think this will most likely take place after the first US Fed rate hike. That being said, the RMB exchange rate is subject to strong depreciating pressure through next year.

Figure 1
Currency Weights in the SDR baskets



Source: IMF and BBVA Research

Figure 2
Focus is shifting to the exchange rate reform



Source: CEIC and BBVA Research

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