Global implications of the Inclusion of the RMB into the SDR

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Abstract

Symbolizing worldwide recognition of Chinese Yuan as an international currency, IMF's decision to include the renminbi (RMB) into the SDR basket carries profound international implications. With the credibility and value of intangibles of RMB boosted, the global demand for the Chinese currency is set to surge. As China continues to develop and reform its financial sector, RMB's role as a global currency will also be enhanced. Given that a current-account deficit is unlikely for China in the short run, it is inevitable for RMB to go abroad by means of capital account deficit. The ever-faster internationalization of RMB will challenge the Chinese government's capacity to steer macro control and to manage financial risks.

China launched the first phase of China International Payment System (CIPS) in Shanghai on October 8th, 2015, making the financial infrastructure a milestone in RMB internationalization. Another milestone arrives on November 30, 2015 when International Monetary Fund (IMF) decides to include Yuan into its Special Drawing Rights (SDR) basket with a weight of 10.92% ， after US dollar and Euro and before Japanese Yen and British Pound. The new basket of SDR, effective October 1, 2016, symbolizes global recognition of RMB as an international currency. It will boost the currency's global standing greatly and has profound international implications.

To start with, the inclusion will significantly boost yuan's international reputation and the value of its intangible assets. In recent years, both renminbi assets held by residents outside of China and the scale of cross-border renminbi settlement have experienced fast growth. By the end of 2014, the non-resident RMB deposit balance in onshore banks (not including Hong Kong, Macao) was 2,283 billion yuan, the RMB deposit balance for major offshore markets was approximately 1,986.7 billion yuan and the outstanding amount for RMB international bonds was 535.1 billion yuan. In 2014, current accounts settled in renminbi reached 6.55 trillion yuan, growing 41.6% year on year. The amount settled in RMB for Outward Direct Investment (ODI) achieved 186.56 billion yuan, a year-on-year increase of 117.9%; the amount settled in RMB for Foreign Direct Investment (FDI) totaled 862 billion yuan, a year-on-year growth of 92.4%. As of the end of April 2015, RMB assets held by offshore central banks or monetary authorities reached 666.7 billion yuan. By the end of May 2015, 32 countries and regional central banks or monetary authorities had signed bilateral currency swap agreements with People's Bank of China (PBoC). The total size of the agreements had arrived at approximately 3.1 trillion yuan. Offshore RMB clearing centers were established in 15 countries and regions, covering Southeast Asia, Western Europe, the Middle East, North America, South America and Oceania. As the inclusion of RMB into the SDR basket boosts the currency's credibility globally, the internationalization process of RMB stands to be accelerated.

Also, global demand for RMB will surge. First, a growing demand is registered for global public goods such as currency. Currently, global public goods suffer from dire shortage and structural deficiency, which was revealed by the dominant role the US dollar plays in international currency system. RMB is urgently needed as a reserve currency to spread risks involved in global financial system. In 2014, while the US contributed 11% of world trade, China accounts for 11.8% of global trade. As of September, 2015, the top 5 major international payment currencies are US dollar, Euro, British Pound, Japanese Yen and Chinese Yuan. The Chinese Yuan manages a share of 2.45% in global payments by value as the US dollar obtains over 40%.Although China stands as the largest trader worldwide, the use of its currency RMB in international payment is grossly disproportionate. At present, over 60 overseas central banks have already included Yuan in their reserve. Upon the RMB's inclusion into the SDR, more central banks are likely to follow their suits. Second, China harbors great potential for outbound investment. In 2014, China overtook Japan in foreign direct investment flow to become second largest outbound investor. However, China only ranks 8th in terms of the accumulated outbound direct investment (ODI) volume, 463.52 billion US dollar lower than Japan in 5th place and 5.59 trillion US dollar lower than the US. As a matter of fact, the accumulated volume of China equals to only 11.55% of the US size .As "the Belt and Road" Initiative develop, Chinese enterprises stand to enhance their presence in countries and regions along "the Belt and Road”. Third, cross-border e-commerce are booming. In 2014, over 13.8 million trading companies are involved in cross-border e-commerce, yielding an e-commerce trade volume of 4.2 trillion RMB or 15.9% of the country's trade volume. The Chinese government is also pursuing an "Internet plus" plan with a view to add momentum to RMB internationalization.

On top of that, as China continues to develop and reform its financial sector, the role of RMB as an international currency stands to be enhanced. By the end of 2014, China's GDP has gone beyond 10 trillion US dollars, second only to the US. It is estimated that China will overtake the US in 2025 as the world's largest economy. Over the past five years, China has contributed an annual 30% to the global newly-added GDP. The US used to be the locomotive of world economy. Now, however, global economic growth is powered by "twin engines”, namely, China and the US. The PBoC has provided a monetary base of 28 trillion yuan, surpassing that of the Fed and of the European Central Bank to become the world's largest. In 2015, significant progress has been made in the RMB exchange rate regime reform and interest rate liberalization. The Chinese stock market levels off after a considerable fluctuation. As of October 2015, China's bond market has amounted to 34.7 trillion yuan while listed companies on its stock market have managed a total market capitalization of 47.7 trillion yuan .In the next five years, booming direct financing, coupled with deeper and wider financial market, will create a solid domestic economic base for the internationalization of RMB.

Besides, given that a current-account deficit is unlikely for China in the short run, it is inevitable for RMB to go abroad by means of capital account deficit. At present, the Chinese Yuan has been widely accepted in Asia and surrounding areas. As China run considerable trade deficits with Korea, Chinese Taipei and other countries and regions in Asia, it makes sense to encourage them to hold RMB first. Still, China needs to take the initiative to output RMB through capital account deficits. A decade ago, Panda bond, a Chinese renminbi-denominated bond from an international issuer was born. However, its development has been quite slow. This is first due to the expectation of Yuan 's unilateral appreciation against the US dollar then , which drummed up the cost of financing; Another reason is that Yuan 's domestic interest rate is higher than that of the US dollar on the international market. Now, both factors are changing: RMB has depreciated mildly against the US dollar; The Fed plans to raise the interest rates of US dollar while the PBoC cuts yuan's interest rate. the timing to issue Panda Bonds is perfect for overseas financial institutions and enterprises. Asian Infrastructure Investment Bank (AIIB), The BRICS New Development Bank (NDB), the World Bank, the Asian Development Bank (ADB), the European Bank for reconstruction and development (EBRD) and other international financial institutions should seize this opportunity to issue renminbi bonds. In addition, China should speed up its efforts in establishing an international stock trading platform so as to encourage foreign companies to get listed on Shanghai Stock Exchange.

Last but not least, the ever-faster internationalization of RMB will challenge the Chinese government's capacity to steer macro control and to manage financial risks. Chinese monetary policy needs to accommodate both domestic and international factors. Previously, when making monetary policy, only domestic liquidity is included. Offshore RMB flow, the impact of cross-border capital flow on Chinese financial system in particular, was not in the picture. For example, in terms of currency issuance, if the policy-making is based on M2 growth rate, it may misjudge the situation. In the hope of better managing liquidity, the money supply on offshore market should be timely and accurately grasped and offshore demands for RMB be determined by quantitative models. With Yuan joining SDR, China must play by the rules of the international monetary system, taking into account possible negative spillover effect in particular. In light of this, it is essential for major countries to coordinate their macroeconomic policies and communicate well with global markets. As RMB internationalization unrolls and capital accounts open further, China should develop preventative measures against risks in a forward looking manner so as to build on its financial risk management capacity.

In conclusion, the inclusion of Yuan into the SDR marks a historic new start in the process of RMB internationalization. In the coming five years, Yuan is set to overtake British Pound and Japanese Yen to become the world's third largest currency. By 2025, Renminbi will grow into one of the global dominant currencies as proportional to fulfilling China's economic role. However, it will not alter the dollar-dominated international monetary system. To realize this, it demands prudence and initiatives from the Chinese government so as to tackle challenges of all kinds. The international community, US included, should support and help RMB in shouldering more global responsibility as it would be a win-win solution conducive not only to global economic rebalance and financial stability, but also to easing the global burden placed on the US dollar.