

CIO Flash

Chinese yuan enters IMF reserve basket

Dec 1, 2015

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The International Monetary Fund (IMF) approves Chinese yuan in reserve basket – China has passed a milestone in its quest to win a bigger global role for the Chinese yuan (CNY).

– The IMF has approved the inclusion of the CNY in its currency basket for Special Drawing Rights (SDR), effective Oct 1st, 2016.

– The CNY will have a 10.92% weight, the third highest weight behind the U.S. dollar (USD) at 42% (unchanged) and the euro (previously 37% and now 31%). The pound sterling and the Yen now each have an approximately 8% weight.

– SDRs are the IMF's unit of account. Their value is tied to the above basket of major global currencies. SDRs can be swapped for them if an IMF member encounters payment difficulties. Inclusion in this basket effectively gives the CNY the IMF's stamp of approval as a global reserve currency.

Central banks around the world to re-allocate currency reserves

– SDR inclusion could boost the Chinese yuan's attractiveness as a reserve currency: Although the IMF decision to add the CNY to the SDR basket does not trigger compulsory CNY purchase for IMF members, we believe this marks a first step towards the world's central banks restructuring their reserve currencies to holding more CNY, depending on the availability and liquidity of China's currency.

– Capital flows: We do not expect big in- or outflows in the short term, given that China has strengthened capital controls in recent months. Looking beyond the immediate SDR impact, there might be three main sources of flows. First, potential outflows from domestic investors and households due to their limited holding of foreign assets. Second, potential inflows from foreign central banks diversifying their assets into CNY denominated assets, and third international investors diversifying further into CNY assets.

– China's bond market to benefit most from an increased global portfolio allocation: Over the next few years, growth of CNY exposure among investors and asset managers is now much more likely to come in the form of CNY-denominated fixed income. This could include bonds issued by both local and foreign debtors and offered in both foreign and local markets. With a size the equivalent of about USD 5.5tn at the end of 2014, the Chinese local bond market is one of the world's biggest.

– Encourage further financial reform in China: We believe that the Chinese government will continue to use SDR inclusion as a catalyst to speed up financial-market reforms, including a more flexible exchange-rate regime and a further opening of the capital account, as outlined in the 13th five-year plan. The opening up of the local bond market has gained high priority after

the SDR inclusion.

– CNY currency policy: China is expected to follow a „strong yuan policy“ in the long term as the discussion of the 13th fiveyear-plan showed. In the short term, however, a continuing global USD strength and weakening Chinese growth figures

might put some pressure on the CNY/USD exchange rate. It is noteworthy that, so far, monetary policy has proven ineffective

and there currently appears to be limited scope for fiscal-policy stimulus.

– China’s equity market should also benefit in the longer term: To be sure, the risk of CNY depreciation following SDR inclusion

may prove a likely negative one for domestic equity markets in the short term. However, increased capital account opening

and further domestic capital-market development, coupled with very low global exposure to Chinese assets currently, could

bring more stock market inflows in the longer term.

– Our CNY forecast for 2016: A slight depreciation in the CNY, with CNY vs. the USD at 6.6 by Dec 2016.

Investments are subject to various risks, including market fluctuations, regulatory change, counterparty risk, possible delays in

repayment and loss of income and principal invested. The value of investments can fall as well as rise and you may not

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Explanation of terms

Glossary

A reserve currency is a foreign currency held in significant quantities by central banks and international financial institutions. Foreign currency reserves allow a country to pay off its international debt obligations or boost its currency's value.

Capital controls are residency-based measures such as transaction taxes, other limits, or outright prohibitions that a nation's government can use to regulate flows from capital markets into and out of the country's capital account.

With China's five-year plan the Chinese Communist Party sets out growth and other economic and social targets, helping define government policy priorities.

Special Drawing Rights (SDR) are an interest-bearing international reserve asset and also serve as the IMF's unit of account. SDRs can be exchanged for the freely usable currencies of IMF members. Each SDR is made up out of the value of five major currencies, namely the U.S. dollar, the euro, the pound sterling, the Yen and, since October 1st 2016, the Yuan.

The Chinese yuan (CNY) is legal tender on the Chinese mainland, also referred to as the Renminbi, RMB.

The International Monetary Fund (IMF), created in 1945 and headquartered in Washington, D.C., is an organization of 188 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world.

The pound sterling (GBP), or simply the pound, is the official currency of the United Kingdom and its territories

The United States dollar (USD) is the official currency of the United States and its overseas territories.

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