LPL RESEARCH

TIMELY TOPICS

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THE IMF, SDRs, AND CHINA'S EFFORTS AT INCLUSION

When you're number one in the world, you garner most of the attention, and there's always someone out there predicting your downfall. When it comes to the U.S. dollar, that premise seems to hold true. LPL Research has received many questions about the dollar over the last several years regarding potential catalysts for its demise. This year, as has been the case before, a complicated, relatively little known economic event is predicted by some to be the "beginning of the end." As before, we believe this situation—the International Monetary Fund's (IMF) consideration of whether to associate China's currency with a financial device called special drawing rights (SDR)—will not mark any meaningful transition for the dollar.

As a complement to our recent *Weekly Market Commentary, "U.S. Dollar Still Stands Tall,"* which focused on the dollar's role as the world's primary reserve currency, this *Timely Topics* takes a closer look at the IMF's upcoming meeting to review SDRs, China's bid for inclusion, and what it all means for investors.

SDR'S CHARACTERISTICS AND ROLE AS A RESERVE ASSET

The SDR was created by the IMF and is mainly used as a supplement to individual foreign currencies as part of a country's official reserve assets. However, it can only be exchanged for certain currencies, its share of official reserve assets is very small (less than 3%), and unlike other reserve assets (such as gold and foreign currency), SDRs can only be held or used by IMF member countries, the IMF, and certain designated official entities. Also, it does not function the same way as the underlying currencies that are used to determine its value—currently the U.S. dollar, Japanese yen, British pound sterling, and euro. SDRs do not trade in foreign exchange (forex) markets. Instead, trades are either conducted voluntarily between member countries, or the IMF may facilitate a transaction if necessary, though this rarely happens.

Changes in the SDR basket will have little to no impact on global financial markets. This is because there are no financial markets that trade SDR-denominated debt or derivatives, and there are no palpable advantages to holding SDRs over the underlying currencies used to determine its value. Neither individual investors nor institutional investors nor corporations have the ability to hold, trade, or use SDRs. Consequently, they are not relevant to investors or the financial markets.

CRITERIA FOR POTENTIAL INCLUSION

The IMF's evaluation of a currency for potential inclusion in the SDR reserve currency basket is based on two main criteria: 1) the size of a country's exports and 2) whether the currency is "freely usable."

Two primary conditions that characterize a freely usable currency are that it is widely used (desirable) and widely traded (accessible). Though ultimately defined and interpreted by the IMF, characteristics such as the amount of the currency held as part of countries' official reserve assets, the amount of international bonds denominated in the currency, and the extent of its use as payment for international transactions help to determine desirability, while trading volume in forex markets is a primary gauge for assessing whether a currency is widely traded.

INCLUSION IN THE SDR CURRENCY BASKET VERSUS RESERVE CURRENCY STATUS

One very important distinction to note, and one that is often confused, is the difference between a currency's inclusion in the SDR basket versus attaining reserve currency status. Inclusion in the SDR basket is not necessary to become a reserve currency (the Swiss franc is used as a reserve asset but isn't in the basket), and reserve status is not a designation conveyed by the IMF or any other organization. It is the result of building trust within the global community characterized by a country's currency having deep and liquid foreign exchange, bond, and derivative markets, as well as widespread acceptance as payment for international transactions. In addition, the country's political, economic, and financial structures need to be seen as secure.

CHINA'S EFFORTS FOR SDR INCLUSION ON ITS PATH TO RESERVE STATUS

The IMF's Executive Board decided not to add China's currency, the renminbi (RMB), also known as the yuan, as a reserve currency to the SDR basket when it last met in 2010. Although it was determined that China's export levels were sufficient, it failed to meet all the criteria of a freely usable currency. Since then, China has made progress to address the RMB's shortcomings, but we believe progress toward meeting the second criteria for inclusion may still be inadequate, and, even if included, the RMB still faces a long road to reserve status.

Addressing most, if not all of the RMB's shortcomings, will require China's government to loosen its grip on its economy, its currency, and its financial markets to allow for greater transparency and mechanisms that enable the market to price risk, set interest rates, and dictate the RMB's value.

Since the RMB was rejected in 2010, China's government has implemented reforms to address these shortfalls (some of which are outlined below), but the reforms will require a significant amount of time to take hold. Even with the progress it's made, China's government still maintains significant control over its country's capital flows. These restrictions limit the RMB's potential for acceptance as a reserve asset. In fact, so far the net result has been more RMB coming into the country than going out.

Barriers to Foreign Investment Remain

Programs such as the Hong Kong–Shanghai Stock Connect (HKSSC) have permitted more cross-border investing between mainland China and Hong Kong,

WHAT'S GOING ON IN SEPTEMBER 2016?

A report issued in early August 2015 by IMF staff proposed an extension of the current basket's composition until September 30, 2016. This does not mean the decision of whether to add RMB to the basket will be delayed. The proposal only refers to the time frame between when potential changes are announced and when the changes would become effective. The report stresses that an extension should not be interpreted as a foregone conclusion that the RMB will be added to the basket. Rather, the purpose of the deferral would primarily be to address concerns raised by SDR users about potential risks and increased costs with introducing a new basket on the first trading day of the year, when most markets are closed.

but the government still has many restrictions on capital flows between the two regions. Evidence of this can be seen in the valuation differences between companies that have their stock listed on both the Hong Kong and mainland China stock exchanges. Also, the amount of securities denominated in RMB in the global bond markets is very small and foreign access to those securities is limited.

China's Currency Controls Prevent the RMB from Being Freely Traded

China maintains a trading band within which the RMB can move. If the value of the RMB, relative to the U.S. dollar, moves outside the stated boundaries, the government steps in to buy and sell currency as needed. The primary purpose has been to keep the RMB's value artificially suppressed, which makes China's goods cheaper for foreign buyers, thereby increasing exports. This has been a key driver of its escalation to the world's second-largest economy, and also has enabled the country to accumulate massive amounts of foreign reserves. More recently, the band has been widened to enable the exchange rate to fluctuate to a greater (though not meaningful) degree.

While its undervalued currency benefited the economy and facilitated the buildup of foreign reserve assets, it has not facilitated the transfer of the RMB outside China's border. A vast amount of the foreign exchange activity in the RMB finds its way right back into the country as foreign businesses sell their local currency, purchase the RMB, and pay Chinese businesses for their goods. In contrast, the import-based economy of the U.S. results in massive amounts of U.S. dollars being exported around the world as we sell our currency (and buy foreign currencies to pay for our imports), which results in the proliferation of U.S. dollars into foreign accounts.

NO IMMEDIATE IMPACT ON THE U.S. DOLLAR'S STATUS

The addition of the RMB to the SDR basket does not have a short- or intermediate-term impact to the U.S. dollar's status as the world's primary reserve currency. As noted above and in the recent *Weekly Market Commentary*, "U.S. Dollar Still Stands Tall," we believe relative accessibility and liquidity remain insufficient in China's financial markets, and though progress has been made over the past several years, the RMB still does not possess all of the characteristics that define a freely traded currency. In contrast, the U.S. equity, bond, and derivative markets are the largest, most liquid, high-quality markets in the world by a massive margin, and the U.S. dollar sets the standard for freely traded currencies.

SUMMARY

The steps China is taking to promote the internationalization of the RMB are consistent with its goal of having it included in the SDR's currency basket, as well as ultimately gaining acceptance as an official reserve currency. While the RMB's addition to the SDR basket is more a matter of when, not if, according to Christine Lagarde, head of the IMF, that alone would not prompt central banks to shift meaningful amounts of their reserve assets in favor of it.

Additional measures are still necessary if China hopes to garner enough confidence throughout the international community to have its currency attain reserve status. The RMB currently represents roughly 1.1% of official foreign reserve assets across 38 countries, whereas the U.S. dollar represents 64.1% across 127 countries. Similar disparities exist when comparing the amount of international debt securities denominated in each currency, as well as the extent of each's use in international transactions.

Even if the RMB is added to the SDR basket later this year when the IMF concludes its regularly scheduled five-year review, we believe it would do little to propel China's currency into a position to challenge the U.S. dollar's role as the world's primary reserve currency, and we expect the financial markets will take little notice. ■

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Currency risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

Investing in foreign and emerging markets debt securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards.

Derivatives involve additional risks, including interest rate risk, credit risk, the risk of improper valuation, and the risk of non-correlation to the relevant instruments they are designed to hedge or to closely track.

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