ChinaIntelligence
Financial and business advice on China

themonthlydragon #9

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November 2015: the month China was embraced by major Western financial institutions

This week, the Renminbi was included in the IMF's basket of SDR currencies. Also, as of December 1, US-listed Chinese companies were admitted in the China portion of the MSCI indices. Both inclusions are small events if you look at their immediate effect. But they are further indications that Chinese assets are on their way to becoming mainstream investment markets in the not-too-distant future. The IMF's decision should strengthen the government's resolve to continue with financial market reforms.

So the IMF has decided: as of October 1, 2016, the Renminbi (RMB) will be part of the basket of currencies representing the so-called «special drawing rights» (SDRs), with a weight of 10.92%. SDRs mostly are a bookkeeping concept used in transactions between reserve banks and the Bank of International Settlements. The RMB's inclusion primarily comes at the expense of the Euro, the weight of which decreased from 37.4% to 30.9%. By far the largest allocation still is to the US$, which has a weight of 41.7%. The inclusion in the SDRs is a **result of China's concerted efforts to liberalize many elements of RMB trading,** like increasing the liquidity in RMB outside of China.

The immediate effect of this inclusion in the SDR will be small, substantial shifts in the currency allocation of institutional investors are unlikely, the demand for RMB will not change short-term due to the IMF's decision. Most countries already hold some RMB as reserve assets, or were considering to do so even before this week's decision. And the inevitable increase in the RMB holdings of private households will take time.

«Look at the movie, not at the snapshot»

The significance of the RMB's inclusion in the SDRs lies in the process, which has brought a much more open market to the erstwhile practically non-fungible RMB. **This process will continue.** Keep in mind that up to 1994, foreigners in China were basically forced to buy «foreign exchange certificates (FECs)» at unattractive rates in order to purchase goods in China. As it is still the case in Cuba today, they were not allowed to use the «ren min bi», the people's currency.

The RMB's inclusion in the SDRs primarily is a **victory for the reformers in China.** It confirms that the steps taken in opening currency (and financial) markets are helpful to achieve some of the government's objectives. These objectives are fully consistent with Beijing's political aspirations and include:

- promoting the RMB as a global currency for trade,
- which should lead to RMB liquidity in all financial centers of the world,
- supporting the RMB to become a global investment currency as a result, which is only possible if financial market and regulatory reforms in China produce attractive investment opportunities, and

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- **establishing the RMB as a global currency with reserve status,** which makes China less dependent on currency and interest rate decisions by other countries; largely market-driven convertibility of the RMB and the cooperation of other countries will be necessary to reach this step.

More RMB flexibility after the SDR decision

The Chinese central bank, the People's Bank of China (PBoC), may have slightly **more leeway to devalue the RMB by a few percent if the US$ strengthens too much** as a result of rising US$ interest rates. But a participation of the RMB in a devaluation race of currencies is very unlikely. Stability, also with respect to the RMB/US$ exchange rate, is much too important for Beijing because **75% of the goods traded across China's borders still are priced in US$ and HK$ (which itself is pegged to the US$).**

The PBoC always managed the US$ exchange rate as a central parameter of its financial policies. **US$ exchange rate stability is important to China.** The overarching policy objective of keeping social stability includes stability of the financial system. And Chinese companies are much more exposed to the US$ than to other currencies. **80% of their foreign currency liabilities are in US$ or HK$.**

The trading volume which is invoiced in RMB will increase further from its current low level of approx. 25%, since the use of the RMB for trading purposes is open to all parties. Transactions have to be registered with the Ministry of Finance, but can be executed as agreed between the trading partners. **Increased acceptance of the RMB increases the chances that projects outside of China can be financed in RMB.** In the context of the «One Belt, One Road» initiative, for example, it would be very useful if infrastructure investments outside of China could be financed by Chinese banks, in RMB.

Today's use of the RMB

- ***Trade:*** *25% of China's cross-border trade is invoiced in RMB (source: PBoC)*
- ***Payments:*** *The world's fifth-most used currency (source: SWIFT).*
- ***FX:*** *Recent setup of several «RMB hubs», incl. Switzerland, so that the RMB can not only be settled via HK anymore.*
- ***Fixed Income:*** *The domestic RMB bond market is the world's third-largest bond market.*
  Active offshore RMB bond issuance in HK, occasional RMB bonds in EU.
- ***Equities:*** *The domestic A-share market is the world's second-largest stock market.*

Intensive use...

The use of the Renminbi among international partners has exploded in the last five years. The Standard Chartered Renminbi Globalisation Index, a benchmark which tracks renminbi-based business activities worldwide, has increased 24-fold in five years (see chart #2).

...but under control

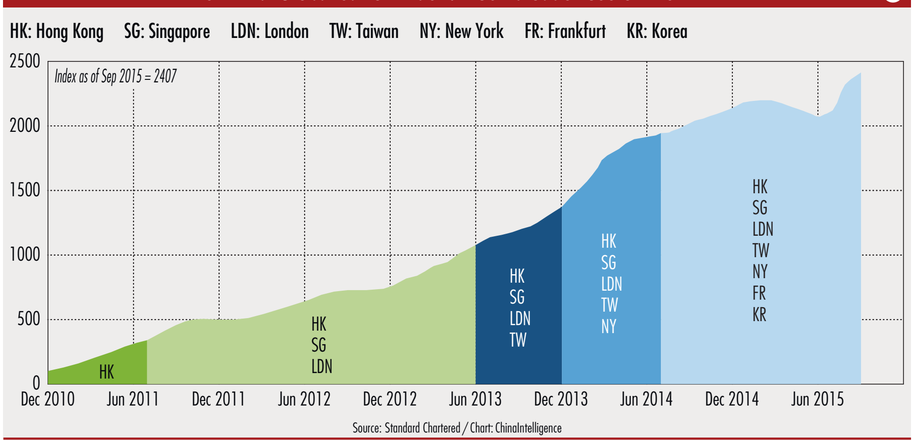
The foreign exchange rates of the RMB have been exposed to market forces only in many, careful steps. It will probably **remain a managed rather than a completely market-driven exchange rate** for a long time. After long years of a fixed RMB/US$ exchange rate, July 2005 brought the transition to a «managed float». In its aftermath, the RMB started to appreciate against the US$ and most other currencies. The band within which the RMB/US$ exchange rate could fluctuate – the exchange rate was set by the PBoC every night – was widened step by step, to +/– 0.5% (from the previous 0.3%) in May 2007, to +/– 1% in April 2012, to +/–2% in March 2014 and to +/– 3% in August 2015. After the financial crisis, the exchange rate was frozen once again between July 2008 and June 2010. Despite these currency bands, however, interventions of the PBoC in the currency market still are frequent.

The significance of the MSCI inclusion

On a separate note, the previously announced partial inclusion of 14 Chinese companies[1] listed in the US in the relevant indices calculated by Morgan Stanley Capital International (MSCI) took place on December 1. They will be fully included on June 1, 2016. As a result, the China weighting in the MSCI Emerging Market Index, for example, will increase between 3 and 4 percentage points. This index alone is tracked by an estimated US$ 1.6 trillion. Such shifts in index compositions thus lead to some reallocation of money, which is why this particular step had been announced a while ago and is implemented in two steps.

This index adjustment is dwarfed by the effects of a potential inclusion of mainland China-based A-shares in global equity indices. Big index providers like MSCI and FTSE are working with China's regulatory bodies to define a way for the eventual full inclusion of the world's second-largest stock market in the relevant indices. Such a step may be a few years away, but as long as Beijing's government proceeds with the opening of financial markets, it will take place. And it **will force investors to at least take a closer look at China** as an investment market. Today, the fact that few foreigners are invested in China[2] is a result of having ignored the China market. In the future, investors may still decide not to touch China, but more and more this will have to be the result of an informed decision.

Renminbi Globalisation Index: much broader use of the RMB 1



Source: Standard Chartered / Chart: ChinaIntelligence

[1] *Among them are these five companies with the highest index weights: Alibaba, Baidu, JD.com, Ctrip, VIPshop.*

[2] *Foreign ownership of China A-shares is estimated at below 2%.*

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Important Indicators	Nov 2015	Oct 2015	Sept 2015	June 2015	Dec 2014	Sep 2014
Quarterly GDP, growth yoy (%)	–	–	6.9	7.0	7.3	7.3
Retail sales of consumer goods, growth yoy (%)	–	11.0	10.8	10.6	11.5	10.8
Official Consumer Confidence Index	–	103.8	105.6	105.5	105.8	105.4
FTCR Labor Demand yoy Index	–	77.2	67.3	63.2	72.6	68.1
Real estate floor space newly started, growth yoy (%)	–	–13.9	–12.6	–15.8	–10.7	–9.3
FTCR mom Home Price Index	–	60.7	59.5	61.0	51.5	50.0
CPI, growth yoy (%)	–	1.3	1.6	1.4	1.5	1.6
PPI, growth yoy (%)	–	–5.9	–5.9	–4.8	–3.3	–1.8
PMI manufacturing	–	49.8	49.8	50.2	50.1	51.1
Caixin/Markit PMI	–	48.3	47.2	49.4	49.6	50.2
Fixed-asset investments, growth yoy (%)	–	10.2	10.3	11.4	15.7	16.1
Required ReserveRatio (large banks) (%)	**17.5**	17.5	18.0	18.5	19.5	19.5
Benchmark rate for 1-year loans (%)	**4.35**	4.35	4.60	4.85	5.60	6.00
Benchmark rate for 1-year deposits (%)	**1.50**	1.50	1.75	2.00	2.75	3.00
New total social financing, growth yoy (%)	–	–30.0	14.5	–6.8	35.0	–26.0
New bank loans, growth yoy (%)	–	1.7	21.3	23.0	44.0	9.0
Exports, growth yoy (%)	–	–7.0	–3.7	2.8	9.7	15.3
Imports, growth yoy (%)	–	–18.8	–20.4	–6.1	–2.4	7.0
Trade balance (USD billion)	–	61.6	60.3	46.5	49.6	30.9
Electricity consumption, growth yoy (%)	–	0.7	0.8	1.3	3.8	3.9
Freight Traffic, growth yoy (%)	–	–	4.1	4.2	7.1	7.7
Iron ore imprts (million tons)	–	75.5	86.1	75.0	86.9	84.7
Coal imports (millions tons)	–	14.0	17.8	16.6	27.2	21.2
Crude oil imports (million tons)	–	26.4	27.9	29.5	30.4	27.6
Bloomberg Commodities Index (BCOM)	**81.40**	90.93	87.82	102.69	104.33	118.69
CSI 300 (China Equity Index)	**3'591**	3'366	3'203	4'473	3'534	2'451
RMB trade-weighted, nominal, indexed (2010=100)	–	125.6	125.9	126.0	121.5	116.0
RMB / USD spot	**6.40**	6.37	6.36	6.20	6.20	6.15

Source: ChinaIntelligence

Key developments we expect for the coming 12–24 months

We expect political, economic and financial stability despite all the looming challenges. Regarding some key topics our expectations are:

- *GDP growth: 2015 year-end run rate of around 7%, 2016: 5.5% to 6,5%, below 5% for 2018–2020.*
- *Labor market: stable to slightly weaker, but with continued wage growth of between 4–7% p.a., at the lower end for high-wage earners, at the higher end for low-wage earners.*
- *Interest rates: one additional cut in the benchmark rates by the Chinese New Year 2016, by 25 bps.*
- *No big stimulus program, but a multitude of smaller and targeted measures and reforms to support the economy.*
- *Real estate prices: a stabilization of prices and demand throughout 2016.*
- *RMB: further weakness of approx. 5% during the coming 12 months from the current rate of 6.40 RMB per USD.*
- *Retail sales growth: approx. 10% p.a.*

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