Renminbi Assets Anyone? Better Start Out Slowly.

- **SDR embraced the Renminbi in 2016**
- **The only non-fully convertible currency included**
- **More investment into China is expected**
- **Don't rush! The markets are opaque and controlled**

The currency unit of The People's Republic of China, the Yuan or Renminbi (CNY) became a reserve currency on September 30, 2016.

The Governor of the People's Bank of China (PBoC), Zhou Xiaochuan, was among many government officials that had lobbied long and hard for the Renminbi to be included in the International Monetary Fund's (IMF) currency unit, *"The Special Drawing Right"* (SDR). This was a boost to the national government as the inclusion aligned with the 67th anniversary of Communist Party rule in China.

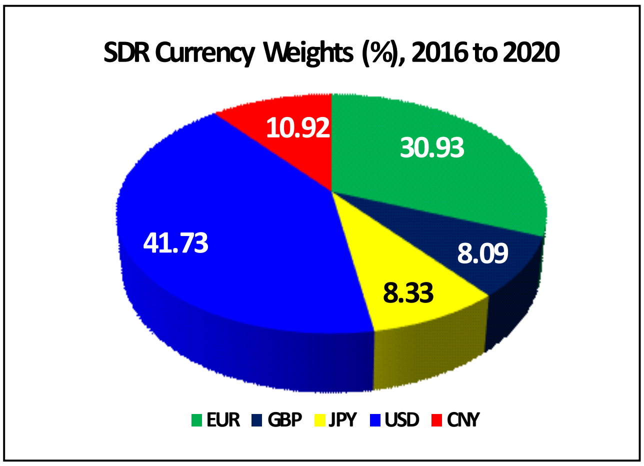


Figure 1: SDR Currency Weights

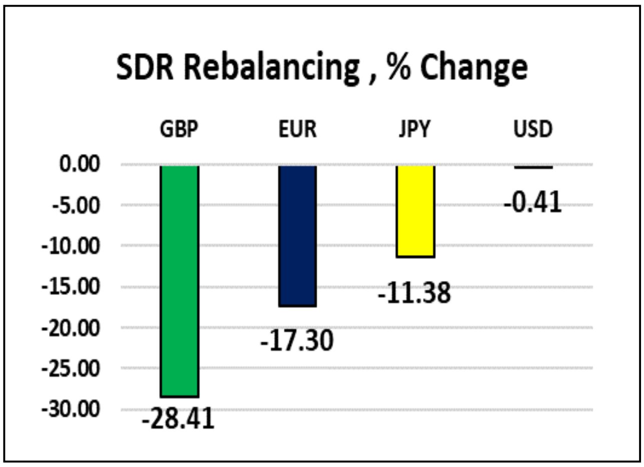


Figure 2: % Change In Weights of $, €, ¥ and £

The SDR is an international reserve asset, created by the IMF in 1969 designed to supplement its member countries' official reserves. As of September 2017, SDR204.2 Billion SDR's, approximately equivalent to USD291 Billion had been created and allocated to members.

SDR's are available for exchange into free floating usable currencies. Its value is based on a basket of five major currencies—the Dollar, Euro, Renminbi, Yen, and Sterling. The weights are shown in Figure 1.

Figure 2 indicates the percentage change of the weight itself:

$$\frac{\textit{2011 to 2015 Weight less 2016 to 2020 Weight}}{\textit{2011 to 2015 Weight}} \quad X\ 100 \quad = \quad \textit{Percentage Change of Weight}$$

As one can see from Figure 2, it is Sterling and Euro that have suffered the greatest decline in their relative weights within the SDR, whereas the Dollar element has hardly been altered.

So, whilst one can accept that this is raising questions as to how foreign exchange reserve holdings may see their composition altered our contention is this. Rather than severely reducing the global dominance of the Dollar, it should be Sterling and particularly the Euro that comes under pressure during asset allocation decisions in the short to medium-term.

Sterling is still a hostage to fortune over Brexit. In turn, the Eurozone faces many hurdles this year. Such as the nature of the new German coalition. The problems that will follow from Italian elections in March. Then add to the pot the Catalonia question in Spain and the ending of the Greek bailout. Plus in the background France is calling even deeper integration, then the Euro is not as secure as markets appear to assume.

Reweighting

In 1990 the US economy accounted for 22% of global GDP and this is expected to decline to 18% by 2020 when the SDR is next scheduled to be reweighted. Leading up to that time one may well see a decline in the share of all foreign exchange trades that are paired to the Dollar from the current level of 90%. The lost ground will not be in favour of the Euro which currently accounts for 40%, but in favour of the Renminbi.

So, we think that Christine Lagarde, Managing Director of the IMF is being extremely diplomatic when she says the inclusion of the Renminbi in the SDR basked is a recognition of China's progress in reforming its monetary, foreign exchange and financial systems as well as advances liberalising its financial markets.

If that were the genuine case, we believe that the Renminbi would account for more of the foreign exchange market than at present. Let's be blunt; the reform is glacial in pace.

The Chinese unit is current only featured in 2% of currency pairs that trade outside of USDCNY. However, for more trade on a CNY handle to happen the Chinese currency would have to become a genuine freely floating unit of account as against one that has to have an official fix every day.

When the SDR is next reweighted it would be no surprise to see the Renminbi make further gains at the expense of the other currencies, however, at this stage whilst one may feel the Dollar will be in line for a reduction it is impossible to say which will suffer the greatest loss of SDR weighting.

China eyes the prize of being the key currency

The author was working the French bank, Société Générale S.A., in the build up to the Euro's launch in 1999. There was plenty of marketing material that hailed the Euro as being the great challenger to the Dollar in terms of global market dominance in terms of bond issuance, swaps, foreign exchange trading and commodities pricing.

Well, 19-years on and that has not happened. At the time many smaller nations welcomed the idea of a challenger to Dollar dominance as it would reduce their currency's fate of their Dollar exchange rate as the Euro would be a counterweight.

Of course, the Euro took a degree of market share from the Dollar, but it has not threatened to usurp it. So, what should we make of the Renminbi's challenge...is it really set to topple the Dollar over the next decade?

Currently the share of the Chinese unit in global trade is just 1.8%, placing it in sixth behind the original SDR members and the commodity driven Canadian Dollar. Why, of all domestic Chinese commerce the Renminbi is only accepted for a paltry 16% of all trade. That doesn't appear to hold much credibility when some analysts suggest the Renminbi is going to be a true safe haven currency.

We doubt that day is here now when it is not yet:

A global medium of exchange ***A unit of account***

A liquid store of value ***Offering developed fixed income markets***

Spotlight acknowledges that Chinese equity funds have performed well, and plenty of emerging market and global equity managers are quite enthusiastic about the market's long-term prospects. Figure 3.

We cannot help but wonder, however, if we are being complacent in overlooking concerns about China's economy.

Our recent paper on the bad debt situation, *"Beware Another Debt Crisis, This Time From The East",*

http://www.spotlightideas.net/images/uploads/SPL%20Beware%20Another%20Debt%20Crisis,%2019-01-18.pdf

highlighted the internal debt problem China faces.

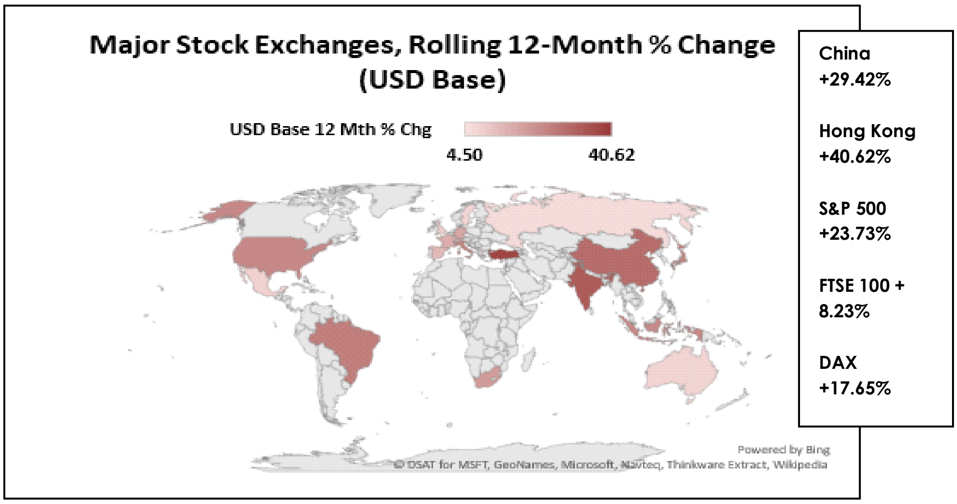


Figure 3: Source www.investing.com and Spotlight Ideas

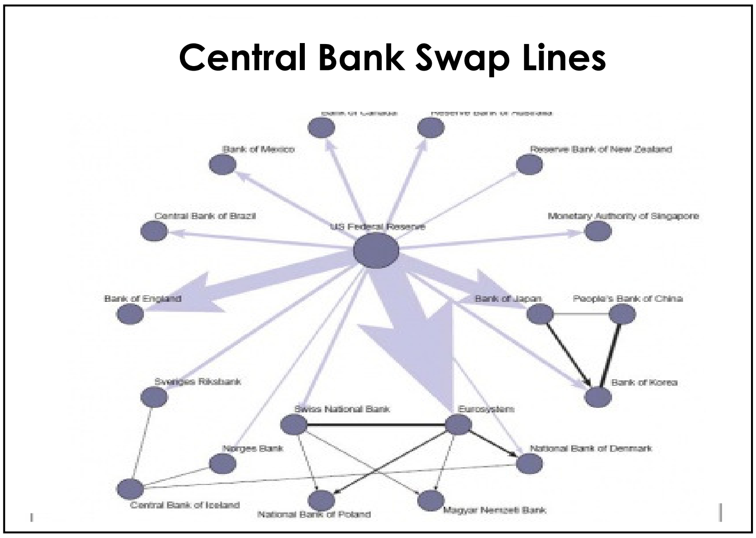
According to the Bank of International Settlements (BIS), China's total debt has grown from USD6 Trillion at the end of the financial crisis to USD28 Trillion at the end of 2016. This means its total debt is equivalent to 260% of GDP, while the debts of Chinese companies are about 170% of GDP.

But, how does the currency shape up when measured against the four tests highlighted earlier.

As a ***global medium of exchange*** China's share is tiny cf. the Dollar and Euro. It's use in trade with and investment into China is relatively small. In fact, PBoC data shows it is no longer growing.

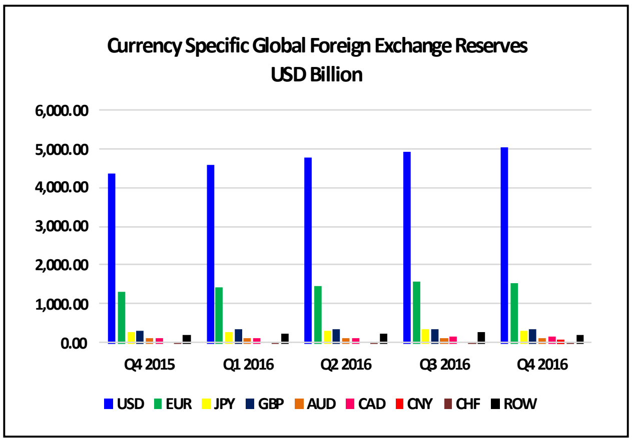
If one considers large payments made between different governments, these are mainly conducted through their respective central bank swap lines. The PBoC has international swap lines worth USD500 Billion, yet the facility is hardly ever tapped. In Figure 4, the PBoC looks like an outsider.

Figure 4:
Source: Bank of International Settlements and Central Banks Databases



To be a ***unit of account*** implies that private investors can invest Renminbi assets and have confidence that they can preserve their purchasing power. Investment in China funds may have risen, however, direct investment into Chinese equities is not substantial at approximately 2.0% of the total and for Chinese bonds the figure is not much more at 3.0%. Matching that is the fact that overseas deposits and loans into China have been in decline since 2014.

Even after the move to include the Renminbi into the SDR the IMF composition of official foreign exchange reserves (COFER) lists the Renminbi share in Q4 2016 at 1.1% cf. the Dollar at 64%. *



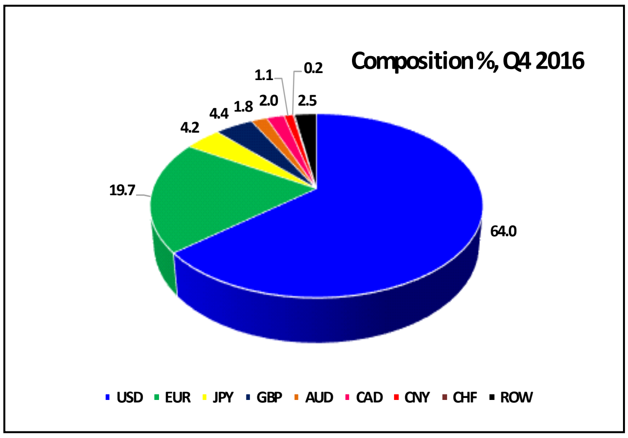


Figure 5 and Figure 6: Source: IMF COFER

* *Unofficial measures suggest the chare of CNY in reserves grew to 2.0% in 2017*

To be classified as a ***liquid store of value*** one would need to see proof positive of a growing share of trade invoices being denominated and paid out in Renminbi...not Dollars. This is simply not the case.

The cross-border circulation of the Renminbi would have a very small impact on the effectiveness of the PBoC's monetary policy, based on the VAR modelling. These suggest the arbitrage risks during the process of internationalisation, given China's high savings rate, may be low. When one considers the ongoing degree of financial repression such as including interest rate controls, credit constraints, capital curtailment the benefit of China's capital account liberalisation might be small.

Looking ahead

China's sheer size mark it out as not being a typical emerging market economy. It does have underdeveloped financial markets; however, we have no doubt that as the Chinese economy becomes even more involved with the globally, it will be driven toward creating a more open and transparent financial sector and a more international banking sector.

That may suggest that at first Chinese banks will in the short-term at least endure problems pertaining to currency mismatches which could become a challenge. These can be overcome as the currency is more widely accepted.

That is turn will increase the international demand for Renminbi denominated assets and so slowly reduce the effects of foreign exchange risk as institutions contemplate capital adequacy requirements.

Spotlight recognises that a more developed financial market is the essential precondition of Renminbi internationalisation. If the process proves to be wide and deep it will be force of nature accelerate the development of the Chinese financial sector through international trade settlements and financial services related to Renminbi denominated international bond transactions.

So much will depend on the Chinese authorities demonstrating a willingness to not intervene. Beijing has a track record of not liking the messy and noisy nature of open markets. For example, China has historically pegged the Renminbi to a basket of currencies filled mostly with the Dollar.

That meant it kept the value in a 2% trading band around a *"reference rate"* that tracked the Dollar's value. This was around USDCNY6.25.

On August 11, 2015, China modified the policy to allow the currency a degree of greater market volatility as it announced that the reference rate would be equal to the previous evening's closing value on the foreign exchange markets. The level of USDCNY immediately fell by 1.9%. This was followed by another decline to USDCNY6.3845.

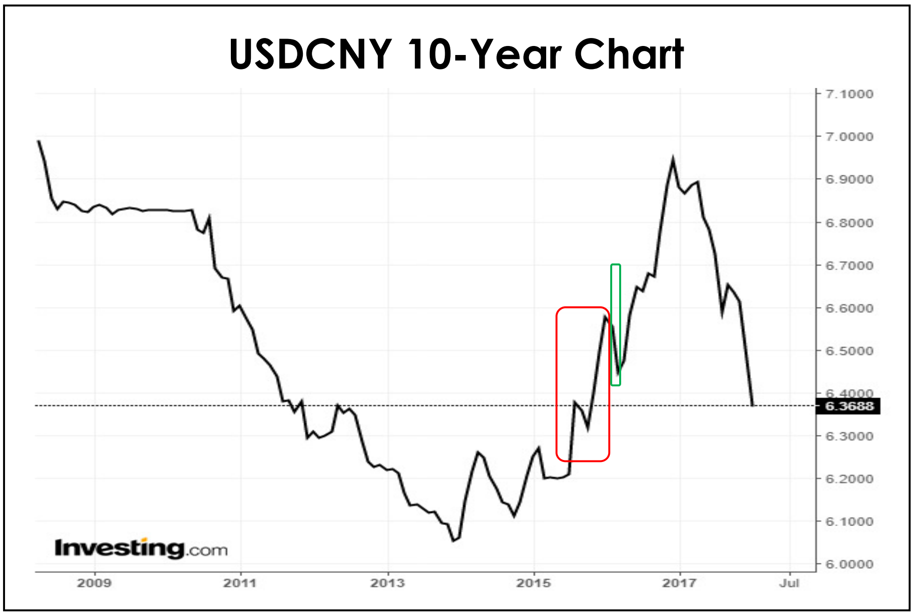


Figure 7: Source: www.investing.com and Spotlight Ideas

PBoC Allows More Market Volatility   *PBoC Intervenes*

That was too much for the Chinese authorities and they intervened to control the rapid descent. It kept the rate in a holding pattern of around USDCNY6.389. By August 24, the rate had weakened to USDCNY6.4064.

This is typical behaviour from Beijing and the inclusion in the SDR will not change the Chinese government's attitude toward allowing full and free convertibility. We believe that China will seek to retain its hold on the currency for at least 5-years, maybe even 10. Meaningful change is simply an item on the horizon.

This underscores the fact that Beijing remains concerned about capital outflows and will only return to the issue of freeing up trade in the Renminbi when the economy is doing better. That is not how markets work and China is guilty of expect the international market to dance to the tune of its choosing.

Of course, over time portfolio's will rebalance, however, during the next three to five years even if the USDCNY rate declines as the Renminbi appreciates, the need to have faith in depth and transparency of the market means Spotlight will be keeping the great majority of its investments in Dollars, Euro, Yen and Sterling.