SDR Bonds Help Reduce Yuan Depreciation Risks for Investors

For investors, holding SDR bonds equates to holding a basket of currencies

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The World Bank (International Bank for Reconstruction and Development) on August 31 issued landmark bonds denominated in the special drawing rights (SDR) in China's interbank market. The bonds, worth 500 million SDR ($700 million), have a maturity of three years and a coupon of 0.49 percent per annum. All payments will be made in yuan, the unit of China's currency.

From the World Bank's point of view, the new bonds will increase the impact of the SDR and enhance its status in global financial markets. For China, the landmark bonds will be part of the nation's wider push to internationalize the yuan and will help investors mitigate yuan depreciation risks.

What exactly is the SDR? It is a synthetic reserve currency created by the IMF in 1969 to supplement its member countries' official reserves. The value of the SDR is determined by a basket of major global currencies. SDRs are allocated to IMF members from time to time, based on each country's quota in the IMF. The composition of the SDR basket is reviewed every five years.

The Chinese yuan will officially join the SDR currency basket on October 1. Subsequently, the value of the SDR will be determined according to the comparative weights of five currencies: U.S. dollar (41.73 percent), euro (30.93 percent), Chinese yuan (10.92 percent), Japanese yen (8.33 percent), and British pound (8.09 percent).

As a significant supplement to a state's sovereign currency, the SDR plays a critical role in special periods, such as during a financial crisis, abnormal volatility of the global financial system, and currency and bank crises caused by capital outflows following sharp U.S.-dollar appreciation.

After joining the SDR currency basket in October, China has to adapt to the fact that more and more countries will use the yuan as a reserve currency. Moreover, there will be more and more yuan capital pools in overseas markets, and the yuan exchange rate is likely to fluctuate drastically in the context of massive inflows and outflows of the currency. Chinese authorities need to adapt to such changes and maintain the stability of China's financial markets by remaining vigilant to any potential risks posed by the global financial system.

What is the significance of issuing interbank bonds denominated in the SDR?

Against the backdrop of excess liquidity globally and low interest rate strategies implemented by some governments, many countries are calling for expanded use of the SDR. The SDR-denominated bonds issued by the World Bank in China's interbank market are the first such bonds in 35 years. The bonds' subscribers are more diversified than before, and such a model offers the IMF a new method for addressing the problems it faces.

Issuing SDR-denominated bonds can greatly increase the IMF's capability to mobilize financial resources and tackle crises, thereby enabling the organization to fulfill its responsibilities as a global lender of last resort and improve the global financial safety net.

The issuance of SDR bonds will significantly increase the global impact of the Chinese yuan and propel its internationalization. The yuan used to account for a miniscule proportion of international monetary reserves. The demonstrative effect of SDR bonds is likely to increase yuan demand.

Second, SDR bonds will reduce yuan depreciation risks and ease the trend of capital outflows. For investors, holding SDR bonds equates to holding a basket of currencies, which can to some extent resist currency exchange rate risks.

What's more, SDR bonds will help enrich China's bond market by offering more investment options. Domestic financial institutions may tap into this business in the near future.

Currently, the pricing and issuance mechanism of SDR bonds is still under discussion, and how much influence it will exert remains to be seen. Evidently, though, investors have responded positively to the bonds, which were oversubscribed by over 2.5 times, with around 50 orders from commercial banks, securities companies and asset managers, and insurance companies, as well as central banks and official institutions.

Pan Gongsheng, Vice Governor of the People's Bank of China, praised the SDR bond issuance, saying it's a trial aimed at making SDR assets more market-oriented. Pan also said it will help domestic and foreign investors diversify their asset allocations and avoid the exchange rate risks of a single currency. Additionally, he said the issuance symbolizes the SDR's expanded use and will help increase stability and resilience of the global monetary system.

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