
SPECIAL REPORT

TD Economics



August 11, 2015

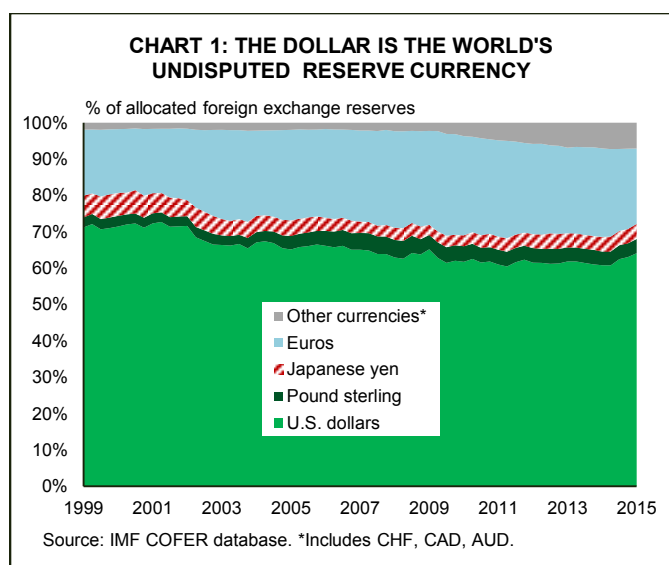
CHINA'S RENMINBI WILL NOT THREATEN THE DOLLAR'S RESERVE CURRENCY STATUS

Highlights

- In a surprise move last night, the People's Bank of China (PBoC) announced a one-time 1.9% devaluation of the renminbi (RMB) – the biggest daily change since it moved a managed float a decade ago. The PBoC's move was telegraphed as necessary to move its daily reference rate with the U.S. dollar closer to market pricing, which had been trading close to its allowed limit of 2.0%. In the aftermath of the decision, the market rate weakened by roughly the same amount, suggesting that a further depreciation of the RMB may be forthcoming.
- The announcement comes as China is taking steps to internationalize the RMB and increase its usage in global trade and investment. The move to a greater role for market pricing is in line with China's desire for the RMB to join the IMF's group of official reserve currencies that make up its special drawing right (SDR).
- This paper takes a step back to look at the challenge posed by the RMB to the U.S. dollar's role as the preeminent global reserve currency. China's size and extensive trading relationship warrant a larger role for the RMB in global reserves, but its potential inclusion in the SDR is not a game changer for the currency's status.
- China still has a way to go in achieving full convertibility of its currency. While the RMB's use in trade settlement has expanded rapidly, authorities have taken a piecemeal approach to easing restrictions on inbound and outbound investment. Regulatory restrictions and frequent government intervention will continue to weigh down RMB utilization in comparison to fully tradable currencies.
- Becoming a major reserve currency will require more than easing restrictions. The dollar's role as a safe haven is supported by the depth of its financial markets and the transparency of its legal and regulatory framework. China has a long road of reform to go.
- Major reserve currency status is also inconsistent with the growth model based on an undervalued currency and net foreign investment that China has leveraged to achieve its rapid growth. Until China's domestic economy is strong enough to handle the flow of foreign goods into its country necessary to supply RMB to the rest of the world, it will not be in the position to be a major reserve currency.
- The bottom line is that the renminbi will not challenge the dollar as the world's foremost reserve currency in the foreseeable future. America's deep institutional advantages ensure that it will retain its position as a dominant global reserve currency.

The economic rise of China and increasing participation in global finance has led to questions about the status of the U.S. dollar as the world's foremost reserve currency and whether it will be overtaken by the Chinese renminbi (RMB).

Recent concerns have centered on the expectation that the RMB will join the small group of official reserve currencies that make up the International Monetary Fund's (IMF) special drawing right (SDR) later this year, alongside the dollar, euro, pound, and yen. This is another step on the road to renminbi



internationalization, but it does not present a threat to the dollar's dominant position.

The recent crash in the Chinese stock market and heavy handed tactics to stem it illustrate the difficulty that Chinese authorities face in moving the financial sector to a market-based system. Reform is moving in the right direction, but will continue to face setbacks. The level of private debt accumulated in China over the past several years represents a considerable source of downside risk to the Chinese economy and its capital markets (see [China's Economy Is Entering a Slower, Riskier Phase](#)). Meanwhile, the Federal Reserve will soon begin a rate hiking cycle that is likely to see capital flow into U.S. assets and further raise the value of the dollar against major trading partners.

The renminbi will not challenge the dollar as the world's foremost reserve currency in the foreseeable future, but over time, it will gain in importance and its share in central bank reserve holdings will increase. This reflects the size of China's economy and importance in global trade. As the Chinese capital account opens and the renminbi becomes easier to buy and sell, it will make sense for countries with trade and investment relationships with China to increase their RMB reserves. However, this will be a slow transition. In addition to removing barriers to trade and investment, China must go much further in reorienting its economy towards domestic consumption and in raising the transparency of its legal and political system, changes that will not occur quickly. Importantly, dollars will continue to be held by countries with strong trade and investment relationships with the United States, including China. As long as American economic policy remains committed to low inflation and takes the steps to put its debt on a sustainable footing,

the dollar will retain its role as the world's main reserve currency.

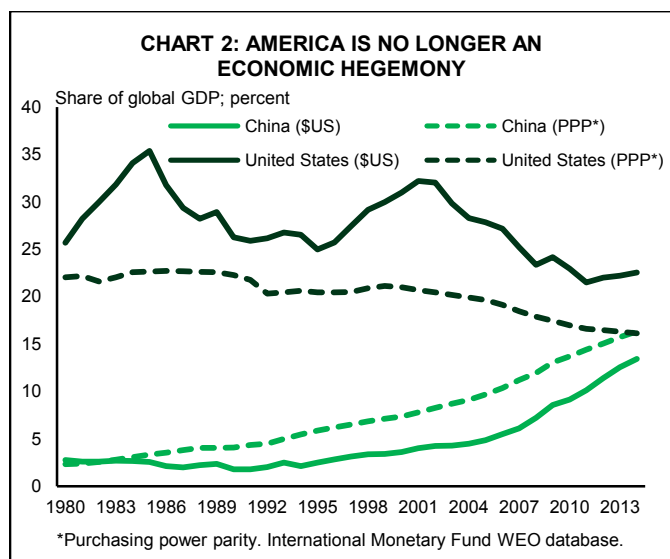
The dollar's reign going on seventy years

The current international monetary framework has its origins in the 1944 Bretton Woods agreement that tied most major economies' exchange rates to the dollar and committed the U.S. government to exchange dollars for gold at a fixed price of \$35 per ounce. The dollar's dominant role in Bretton Woods reflected the hegemony of the American economy relative to the rest of the world. Following the Second World War, America's economy represented over 30% of global GDP, making it by far the largest national economy in the world, surpassing all of Europe and much larger than any other individual country with its own currency. (China's economy at the time was around 5% of global GDP).

However, America's relative size was not the only factor behind the dollar's position. Prior to World War I, the dollar played a very minor role in international finance. The pound sterling was the world's main reserve currency. As Barry Eichengreen notes, at the onset of the war, "sterling accounted for roughly half of all of the foreign exchange reserves of central banks and governments, the French franc 30 percent, the German mark 15 percent."¹ The dollar was practically a non-entity.

America's absence was glaring, given that it had been the world's largest economy for over the past 30 years. A big part of the problem was that the United States lacked a central bank. The Federal Reserve was only established in 1913. Before the Federal Reserve, America was prone to bouts of financial crisis that made the dollar an unattractive place to finance trade or for foreigners to hold investments. The establishment of the Federal Reserve gave America a lender of last resort that could stabilize interest rates and limit bank runs. The Fed also became a strong supporter of the dollar's internationalization by purchasing trade acceptances used in international finance, helping to develop the market for dollar-denominated debt.

Still, even with the advantage of economic size and a stable financial system, it took the devastation of two World Wars to knock the pound sterling off its pedestal. The First World War threatened what had been the pound sterling's great strength – its relative stability. As a result of the war, the pound fluctuated wildly with respect to gold, while the dollar remained stable. The Second World War completed the job. By the war's end, Britain's economy was in shambles and its



government deeply in debt – Britain’s public debt to GDP approached 250% – much of it owed to the United States.

While the Bretton Woods fixed exchange framework did not last – in 1971, President Nixon suspended dollar convertibility with gold – the dominance of the dollar in global reserves has remained in place. The share of total reserves held in dollars today (in value terms) is roughly in line with its long-run average, lower than its estimated 80% share in the 1970s, but higher than its 50% nadir in the early 1990s.² Other challengers to the dollar – the yen in the 1980s and the euro in the 2000s – have succumbed to their own structural problems. However, just as these rivals failed to supplant the U.S. dollar’s dominance in global financial markets, a new challenger – the Chinese renminbi (or yuan as it is also known) – has stepped in to take their place.

The renminbi’s big bang onto the world stage

The United States no longer dominates the economic league tables the way it once did. In fact, measured in purchasing power parity terms, China is now slightly larger than the U.S. at 16.5% of global GDP (compared to 16.3% for the United States) in 2014 according to the IMF. Measured in dollars, America is still bigger at 22.5% of global GDP, but China is not far behind at 13.4% and gaining ground (see Chart 2). In terms of international trade, the United States is still the biggest importer, but China is the larger exporter. Measured in terms of total trade (both imports and exports), China has the edge, with a total value of \$4.3 trillion (see Chart 3).

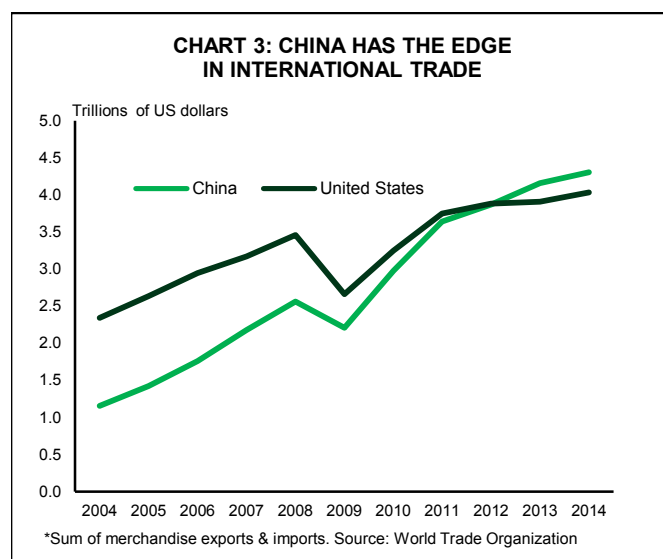
Nonetheless, similar to the dollar’s position prior to the First World War, the RMB’s usage in international finance remains in its infancy, but for different reasons. Up until

the last decade, the RMB was strictly controlled by Chinese authorities. Foreigners were restricted from obtaining the currency and its exchange rate was kept undervalued as a tool to achieve export-driven growth.

History may not repeat, but it often rhymes. Just as the Federal Reserve was instrumental in facilitating the international use of the dollar, Chinese policy has moved in favor of supporting RMB internationalization. The first step in this process occurred in 2005, when the People’s Bank of China (PBoC) loosened its peg with the dollar and began allowing the RMB to fluctuate within a gradually increasing band. Since then, the RMB has gained 30% in value against the dollar.

A second important step came in 2009 when China announced an RMB trade settlement program. The program allows Chinese exporters and importers to make and receive payments with foreigners in RMB. This was significant because it created a means by which foreigners could attain the currency. Before this program, international trade was settled in foreign currency (mainly U.S. dollars). The trade settlement program occurred alongside exchange rate reform that allowed the RMB to be fully convertible to dollars outside of the mainland in Hong Kong.

While initially the trade settlement program was only open to select Chinese companies, starting in March of 2012, all licensed mainland importers and exporters are allowed to settle their trades with foreign companies in RMB and remit the currency in the mainland. Unsurprisingly, with the encouragement of Chinese authorities, the share of Chinese trade settled in RMB has grown considerably from just 3% in 2010 to close to 20% currently.



China's "Managed Convertibility" Programs: Part 1 (Inbound Investment)

Qualified Foreign Institutional Investor (QFII)

QFII, launched in 2002, was the first program allowing foreign institutional investors access to capital markets in China. Investors (financial or credit institutions) must apply for qualification to the China Securities Regulatory Commission (CSRC) and investment quota to State Administration of Foreign Exchange (SAFE). Once approved, the QFII opens a foreign exchange account and an RMB account with its designated trustee and a securities account in the China Securities Depository and Clearing Company. Through these accounts, foreign currency exchange is administered and securities are invested. With the minimum quota set at \$50 million and maximum at \$ 1 billion, QFII is allowed to invest in equities, open and closed-end funds, ETFs, stock index futures (for hedging purposes only), bonds and fixed income products traded in interbank bond market, options, placements in small and medium enterprise (SME) bonds, and other investments approved by CSRC and PBoC. In terms of asset allocation, there are general guidelines of at least 50% allocation to equities and not more than 20% to cash. Minimum lock-up periods applies and is subject to SAFE approval; monthly fund remittance (weekly for open-ended funds) should not exceed 20% of the QFII's total assets.

Renminbi Qualified Foreign Institutional Investor (RQFII)

RQFII provides access to mainland securities for overseas investors using offshore Renminbi. The pilot RQFII started in December 2011 in Hong Kong. In October 2013, London became the first RQFII-eligible jurisdiction outside of China. The application process is similar to QFII, where the potential investor must seek approval from CSRC and obtain the investment quota from SAFE. Once the approval is granted, the RQFII must authorize a QFII custodian to transact on its behalf. As of June 2015, there are 132 RQFIIs with the total approved quota of RMB 391 billion and the total ceiling of RMB 920 billion. One of the main advantages of RQFII is the ability to invest without capital flow or asset allocation restrictions. RQFII fund holders have the ability to establish investment funds and make investment decisions according to their firm's skill set and risk-reward strategies without implementing costly synthetic fund structures and exposure to counterparty risks. Even though the program is less than 50% utilized, it is expected to grow over time with potential expansion of the ceiling.

As a result of the trade settlement program, offshore holdings of RMB has grown from virtually nothing in 2009 to RMB 1.7 trillion in May 2015. Roughly half of these deposits are in Hong Kong, with most of the remainder in Taiwan and Singapore, and Korea. However, over the last two years, settlement centers have expanded to include a number of international cities. London, Frankfurt, Seoul, Paris, Luxembourg, Doha, Sydney and Toronto were announced as new offshore RMB clearing centers in 2014, followed by Kuala Lumpur and Bangkok in 2015. The opening of these settlement centers, in addition to currency swap agreements between the PBoC and foreign central banks to provide access to RMB liquidity is likely to lead to further growth in RMB trade settlement.

Restrictions on investment in RMB lifting more gradually

China has made swift progress in advancing the roll of RMB in international trade, but it has taken a more incremental approach to eliminating restrictions on investment in the currency. So far, the approach has been one of "managed convertibility," opening up foreign investment only to select

groups with strings and quotas attached.

At present, the main conduits for foreigners to invest in China are the Qualified Foreign Institutional Investor (QFII) and the Renminbi Qualified Foreign Institutional Investor (RQFII). The details of these programs are in the text box, but suffice it to say that they live up to their names – there are restrictions on who can invest, how much they can invest, and what they can invest in. Mainland Chinese citizens' ability to invest abroad also remains restricted. The main program for mainland investors is of similar structure to the foreigner program. The Qualified Domestic Institutional Investor (QDII) program allows domestic financial institutions to invest in select offshore securities.

Still, China has been announcing new liberalization programs at an increasing rate. In November 2014, it announced the Hong Kong-Shanghai stock connect, which allows mainland investors to invest in Hong Kong's stock market and foreigners to invest in Shanghai's. In May of this year, it announced a pilot Qualified Domestic Individual Investor program, known as QDII2 that when it is launched will allow wealthy private investors in six major Chinese cities to invest in a broader array of foreign investments.

And in July, it declared that central banks and sovereign wealth funds could invest in its domestic interbank lending market without pre-approval or quota.³

Joining the IMF's official reserve currency club a key motivator for easing RMB restrictions

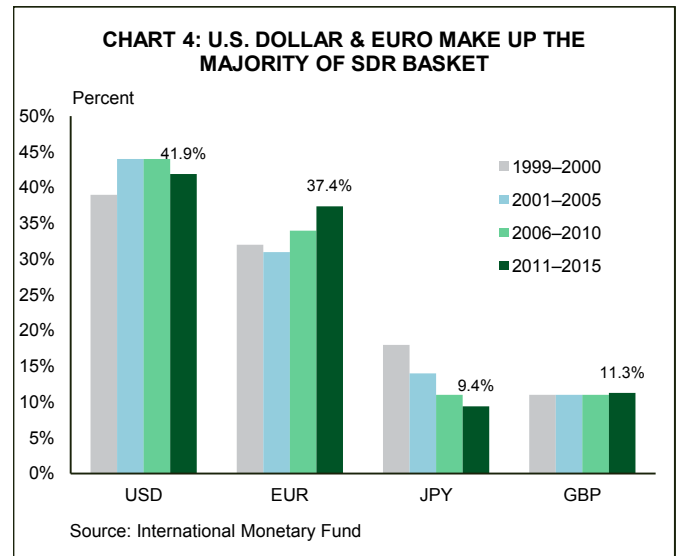
The main reason that China has accelerated its efforts to increase the use of the RMB is its desire to have it added to the IMF's special drawing right (SDR) basket, putting it in a small group of recognized reserve currencies. The IMF makes its decision on the composition of this basket every five years and is expected to do so before the end of 2015. Before we get into China's motivation for joining the SDR, we must explain what it is.

SDRs are an interest-bearing reserve asset originally created by the IMF in 1969 to help maintain the Bretton Woods fixed-exchange rate system. The motivation for their creation was to meet the demand for reserve assets without having to create additional U.S. dollars, which had the byproduct of driving up the market price for gold and making it increasingly difficult to maintain the \$35 an ounce dollar peg. The SDR was intended to play a significant role in foreign exchange reserves, but with the collapse of the dollar-gold peg in 1971, it has remained marginal.

The SDR is not a currency, but rather a claim on the freely convertible currencies of IMF members. Its value is determined by the weighted market exchange rates of the currencies in its basket. The last weightings were decided in 2010 and put into effect on January 1, 2011. The dollar makes up 41.9% of the SDR basket, the euro 37.4%, the pound 11.3% and the yen 9.4%. The IMF allocates SDRs solely to countries (private entities cannot hold them). To date there has been a cumulative allocation of 204 billion SDR, which, is worth about \$285 billion dollars. This represents 2.5% of the world's total currency reserves.

SDRs still play a relatively small role in reserves for two main reasons. Firstly, there aren't very many of them and new ones are only created on an ad-hoc basis – the last major allocation was in the aftermath of the 2009 global financial crisis. Moreover, the majority of countries who hold them are developed countries that have little need for them. Secondly, SDRs can only be exchanged with other governments or the IMF itself. They cannot be used to settle trade, but only as a means to acquire actual currency from other IMF members.

So, why does China want the RMB to join the SDR? Perhaps most pertinently because it will tell the world that



its currency is worth holding in reserve and is safe to do so. The IMF's criteria for inclusion in the SDR basket is that it be freely usable, which the IMF defines as "a currency that is widely used for international payments and is widely traded." China's progress on the payments front is undeniable, but as discussed above, it still has some way to go to make the currency fully convertible for investment.

A second reason that China is interested in the SDR is its desire for it to play a more important role in global reserves than it currently does. This would require significant changes to its structure – allowing it to be held and traded by private entities for example and dramatically increasing its allocation. This is likely a long way off, but including the RMB in the basket is one step in the direction of a more representative global reserve asset.

The IMF has noted the deficiencies in the RMB's convertibility, referencing the spread between onshore and offshore values of the RMB, a lack of transparency in financial data, and caps on deposit rates, among other things. Still, the IMF has affirmed that China is taking the steps to remedy these deficiencies and may therefore decide that the RMB is freely usable *enough*. Regardless of this year's decision, China's growing importance on the international stage suggests that it is likely only a matter of time before it is allowed to join the club. When it does, China will also likely disclose its reserve holdings to the IMF, which would reduce the 'unallocated' portion of reserves significantly and provide more clarity on the world's allocation of foreign exchange reserves.⁴

RMB's inclusion in the SDR is not a game changer

Given the SDR's minor role in international reserves,

China's "Managed Convertibility" Programs: Part 2 (Outbound Investment)

Qualified Domestic Institutional Investor (QDII)

The QDII program, launched in April 2006, allows licensed domestic fund management and securities companies to use funds raised in China to invest overseas. As with the QFII/RQFIIs, domestic institutions must apply for an investment quota with SAFE and set up an overseas custodian account for transactions and settlements. Once the funds are raised, the QDII may invest in a range of financial instruments, such as government and corporate bonds, equities, funds, structured products and financial derivatives. However, direct investment in real estate, precious metals, and commodities as well as securities financing (except financial derivatives) and short selling activities are prohibited. Additionally, there are limitations on geography and asset allocation.

Qualified Domestic Individual Investor (QDII2)

The so-called QDII2 program, which is expected to be rolled out within the next year, aims to address capital inconvertibility for domestic high-net worth individuals. Media reports cite 6 pilot cities: Shanghai, Tianjin, Chongqing, Wuhan, Shenzhen, and Wenzhou. Residents of these cities with a minimum of RMB 1 million of net financial assets will be allowed to purchase financial, real estate and industrial investments overseas. Annual foreign exchange conversion limit of USD 50,000 is expected to be relaxed for purposes of QDII2.

the addition of the RMB to the SDR is more of recognition for the efforts that China has made to internationalize its currency, than it is itself a game changer. Importantly, the share of a currency in the SDR does not guarantee a requisite share in overall foreign exchange reserves. The U.S. dollar's share of total currency reserves is much higher than its 41.9% SDR share. Total claims in U.S. dollars represent 65% of allocated reserves reported to the IMF. The euro's share is a fair bit lower at 21%, while the yen and pound sterling are relatively small players at just 4.1% and 3.9% respectively (see Chart 1 on page 2).

A crucial limiting factor to growing the RMB's share in global reserves is how quickly China removes the remaining restrictions on investment flows to and from the country. However ingenious China's efforts to improve the flexibility of the "people's currency" in global capital markets have been, regulatory restrictions and frequent government intervention weigh down its utilization in comparison to fully tradable currencies. The PBoC's surprise announcement of a 1.9% devaluation of its currency peg is illustrative of this point. While the move telegraphed as necessary to bring it in line with market rates, the market's reaction was to follow the PBoC's peg downward. The context of the move – a slowdown in economic growth and flagging exports – was not lost on market participants, and the response appears to suggest further depreciation is forthcoming.

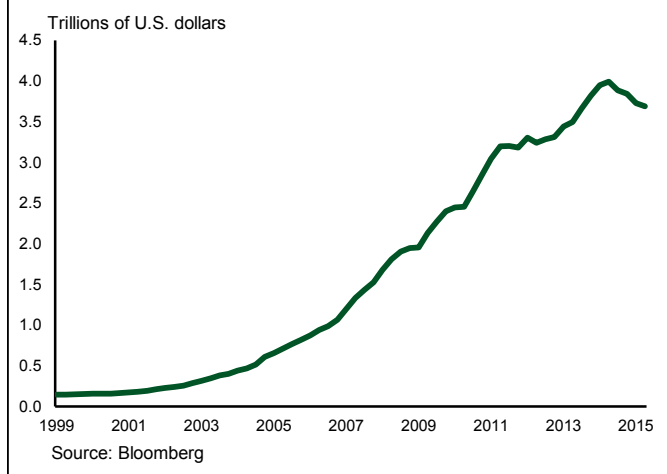
The reaction of policymakers to the Chinese equity market nosedive also showed the instincts of authorities to control the outcomes of financial markets when they are not to their liking. As stock prices fell, more than half of

market trading was suspended; forcing liquidity seekers to sell other assets, like interbank bonds, which cascaded losses into those markets. Additional restrictions on short selling, futures trading and IPOs restrained domestic risk hedging and raised the price of options and futures tied to Chinese stocks in international markets. Such experiences provide much needed information on the spectrum of risks involved when investing in a state-controlled market that may diminish its attractiveness to foreign investors. China is moving the dial incrementally, but it has a long way to go in building credibility and liquidity within its financial system to match the sophistication of the U.S. and others.

Another challenge to the RMB becoming a major reserve currency is the orientation of its economy towards exports and investment. The role of a major reserve currency comes with responsibilities as well as privileges. One of these is that if your currency is going to be stored by others in reserve, foreigners must have a way to accumulate it. This requires either buying more foreign goods than are produced domestically – running a current account deficit as the U.S. does – or lending and investing more in the rest of the world. Chinese authorities have for decades done the opposite. The exchange rate has been used as a means to make exports competitive and capital has been restricted from leaving the country. This has resulted in the accumulation of \$4 trillion in foreign exchange reserves – equivalent to roughly 40% of China's GDP.

The growth in China's foreign reserves – of which 65% or so is estimated to be in dollar-denominated assets – illustrates one of the elements that support the dollar's role as

CHART 5: CHINA'S FOREIGN EXCHANGE RESERVES HIT A PEAK OF \$4 TRILLION IN 2014



a global reserve currency. In addition to insurance against capital flight, countries build dollar reserves in order to gain a competitive advantage and sell more goods to the world's largest importer. This works because the U.S. is a consumption-based economy. China, on the other hand, is not. Consumption is less than 40% of China's economy. Chinese economic reforms are aimed at making this transition, but for authorities that have for decades used the value of the currency as a means to drive growth, a stronger RMB may not be such a welcome development. The recent devaluation is a reminder of this perception.

Indeed, the drive to internationalize the RMB is coming at the same time that there are increasing signs that the Chinese economy is slowing dramatically and capital is leaving the country. In announcing its devaluation, the PBoC was careful to state that it was necessary in order to move to a more market-based system and still consistent with its financial liberalization goals. Still, further depreciation would not be surprising. Given the dollar's swift appreciation over the last year, the price of maintaining the RMB's managed float with the dollar has been a significant loss of competitiveness against a majority of its trading partners. Achieving adequate economic growth and avoiding capital outflows may not always be congruous with its goal of becoming a major reserve currency.

Don't count America out

As with other fiat currencies, the future of the RMB will be determined by the confidence of investors in the Chinese economy and expectations for monetary policy. One can make a good long-term case for the RMB based on the reform agenda and growth prospects. However, there are

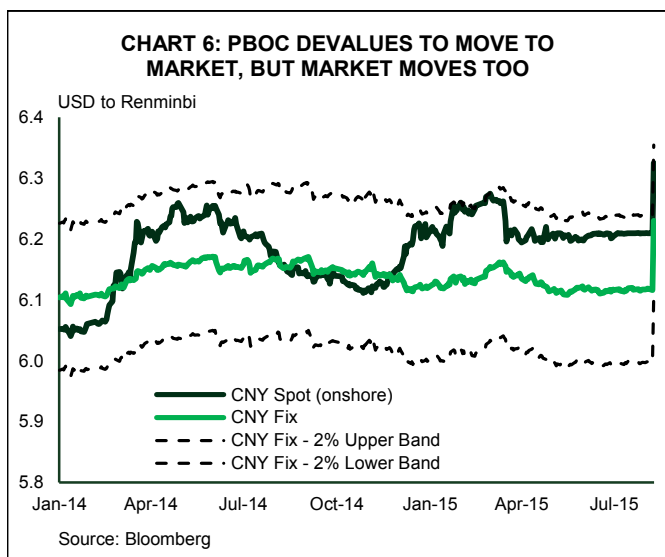
also notable downside risks to Chinese growth over both the short and medium term. First and foremost, the level of debt in China has now become an impediment to further policy intervention as well as a risk factor for the bond market.

At the same time, America's strengths will remain in place, especially its strong legal framework and deep and liquid financial markets. History has shown that it takes both the right moves by one currency and the wrong moves (or extreme global forces) to knock off a reserve currency. An economy with a credible central bank focused on maintaining steady, low inflation will continue to be an attractive place for international investors. While there are long-term risks in America surrounding the level of public debt, there is little risk of an immediate debt crisis. America's problems also have relatively well understood solutions, even if the politics of getting there can make reaching them a belabored process.

America also has a strong incumbency advantage – the dollar is a known quantity whose assets have a long history and track record. This is a high hurdle for any currency to overcome, especially one that has up until the last decade, been a complete mystery. Given the size of reserves that countries like China hold in dollars, they have an interest in insuring that any attempt to move away from them does not destroy their value. This insures the process will be gradual.

Still, the world is becoming increasingly multi-polar. The size of the Chinese economy demands it have a more important role in global reserves. According to research by the BIS, America's share of currency reserves is explained less by the size of its economy relative to the rest of the world and more by the correlation (or co-movement) of currencies relative to the dollar. The greater the share of currencies that move with the dollar, the greater the share of reserves that are held in dollars. As the RMB becomes more market-driven, countries that have strong relationships with China will see their currencies move more in line with it. Countries in Asia especially are likely to increase their holdings of RMB denominated assets.⁵

The implications of this for the United States are not all negative. While America's role as the world's reserve currency has been called an "exorbitant privilege," it may also be an exorbitant responsibility. This is especially true in the current demand-constrained, low interest environment. One of the explanations for this is the significant flow of capital into the U.S. from emerging markets like China. As Ben Bernanke has written, "the diversion of 6 percent of domestic demand to imports provides an alternative explanation



to secular stagnation for the failure of the US economy to overheat in the early 2000's, despite the presence of a growing bubble in housing.⁷⁶ A less concentrated international monetary system could be beneficial to both financial stability and the growth prospects of the United States.

The bottom line

China is moving its currency toward greater international acceptance. Given the size of the Chinese economy and its importance in world trade, the RMB will continue to increase in importance. With the support of Chinese authorities, the share of Chinese trade that is settled in RMB will continue to increase. As it does, the amount of RMB held abroad will also grow, especially among countries in Asia with strong trading relationships.

Nonetheless, while changes have been swift over the last several years, several hurdles remain in achieving convertibility. Inclusion in the SDR is recognition of China's progress to-date, and while providing official status, will not in itself make the RMB a major reserve currency. For-

eign purchases of RMB-denominated assets will continue to be limited by the lack of depth and liquidity of its bond market as well as the tendency of Chinese policy makers to intervene and manage market outcomes. These have been most recently highlighted by the significant volatility within the country's stock market and the authority's reaction to its correction. Forecasting an expanding international role of the renminbi thus relies on anticipating how fast Chinese authorities are willing to implement change. If history is any guide, this is likely to be a gradual process that will be measured in decades rather than years.

Perhaps just as important, China's economy faces a number of structural challenges that are likely to slow its progress relative to the past decade. China's growth model was dependent first on exports and more recently on credit-driven investment, much of it directed to inefficient state owned enterprises and dubious local government infrastructure. The policy tools used to drive growth – an intentionally weak exchange rate, strict capital controls, and ceilings on deposit rates are now being unwound, but the imbalances they have created remain in place. These imbalances now pose a clear downside risk to economic growth and financial stability. All of this is occurring as China's demographics are moving against them and will soon weigh on growth, just as in advanced economies.

China's problems are not intractable, but neither are America's. Importantly, a stronger RMB with an increasing role in foreign exchange reserves need not pose a threat to America's currency or its economy. The dollar's supremacy has held up against a number of challengers including the yen, and more recently the euro. America's fate is in its own hands. As long as it retains a commitment to low inflation and a credible program to put its debt on a sustainable path, its deep institutional advantages ensure that it will retain its position as a dominant global reserve currency.

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Appendix: China's "Managed Convertibility" Programs: Part 3 (Other programs)

Shanghai-Hong Kong Stock Connect

The Shanghai-Hong Kong Stock Connect program, introduced in 2014, establishes access between onshore (Shanghai) and offshore (Hong Kong) stock markets. At the initial stage, only "A" shares (shares listed in Shanghai and denominated in RMB) that have a corresponding "H" shares (shares of mainland companies listed in Hong Kong and denominated in Hong Kong dollars) are available for trading. Trading activities are subject to daily and aggregate quota set on a "net buy" basis, which means that unlimited sell orders are permitted. The aggregate quota is set at RMB 300 billion for "northbound" (to Shanghai) and at 250 billion for "southbound" (to Hong Kong). As of July 2015, total northbound trading turnover (buy+ sell) was equal to approximately RMB 196 billion, while southbound trading turnover stood at HKD 93 billion. It is important to note that no day trading is allowed in the onshore market; while short selling is limited to the covered type and margin trading is restricted to margin trading-eligible securities.

Pilot Free Trade Zones

The China Pilot Free Trade Zone (FTZ) was first launched in Shanghai in September 2013 and expanded to three more areas in December 2014. It permits offshore investing for Chinese nationals living within the FTZ and onshore investing for foreign individuals working in the FTZ. The program also offers cross-border lending, allowing FTZ-based companies to borrow from offshore banks. However, authorities have set up restrictions on RMB borrowing capacity and funds utilization, which make this feature somewhat limiting.

Mainland-Hong Kong Mutual Recognition of Funds

Mainland-Hong Kong Mutual Recognition of Funds was implemented on July 1, 2015 and allows eligible Mainland and Hong Kong funds to be distributed in each other's market. Equity, bond, mixed funds and index-linked ETFs with a minimum size of RMB 200 million operating for at least one year are eligible, while gold ETFs, fund of funds and structured funds are not. There is a program utilization quota of RMB 300 billion and a maximum requirement for the investment and subscribers in the "host" (vs. "home") market.

Endnotes

1. Eichengreen, Barry (2010-12-16). *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System* (p. 22). Oxford University Press. Kindle Edition.
2. Eichengreen, Barry (2010-12-16). *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System* (p. 64). Oxford University Press. Kindle Edition.
3. Financial Times (2015-07-15). China widens foreign access to bond market. <http://www.ft.com/intl/cms/s/0/ca5f984c-2aad-11e5-8613-e7aedbb7bdb7.html#axzz3iEeUxpeR>
4. The IMF collects data on the composition of foreign exchange reserves from 147 reporting members and publishes aggregates under their COFER (Currency Composition of Official Foreign Exchange Reserves) database. This data is reported to the IMF on a voluntary basis. Some countries do not report their specific currency composition but only a value of total reserves held (i.e. in US dollars) which are then classified as “unallocated”. China does not report its currency allocation to the IMF and is responsible for a large share of “unallocated” world reserves.
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