SPECIAL ISSUE

CHINA ON THE GLOBAL STAGE

Yuan internationalization, the SDR basket and the Asian Infrastructure Investment Bank

The last decade has seen China rocket up the global economic rankings. Now its standing in international finance is starting to catch up. The yuan is emerging as a major international currency. The Asian Infrastructure Investment Bank shows China flexing its muscles in global governance.

This report brings together recent analysis from Bloomberg Brief on the causes and consequences of China’s rise in international finance.
China's Yuan and AIIB Wins Symbolic, Not Yet Substantive

China is riding high with its leadership of a new development institution and enhanced international standing for the yuan. The hard work is still to come.

The past few weeks have been positive for China's position in the international financial system. The Asian Infrastructure Investment Bank has attracted 57 prospective founding members. Subscribed capital of $100 billion — if the aspiration is achieved — will give it a lending capacity comparable with that of the Asian Development Bank.

At the International Monetary Fund's spring meetings in Washington D.C., the yuan moved a step closer to reserve currency status. Managing director Christine Lagarde said China's financial reforms were "very positive steps" toward including the currency in the SDR basket. The Fund also edged toward removing its long-standing assessment of the yuan as undervalued.

China has played its cards effectively. In terms of international payments, the yuan is not in the top ranks of global currencies. China's capital account remains controlled, which means it's a stretch to describe the currency as "freely usable" — a requirement for inclusion in the SDR basket.

That means expectations and politics are playing a critical role in the SDR decision. Expectations are driven by China's continued rise, with potential to rival the U.S. as the world's largest economy in the next decade. The launch of the AIIB will help shift the substance and the politics. AIIB loans might help push the yuan as an international currency. If China does not get a bigger voice in the IMF, its leaders can focus on their own institutions.

So far, so good. The challenge for China is that moving from symbolic to substantial victories will be tough to do. The yuan's admission into the SDR basket would legitimize its use as a reserve currency. Even so, barriers to its widespread adoption remain formidable.

Most obviously, more widespread international use of the yuan requires accelerated opening of China's capital account. So far, the total quota for foreign participation in its financial markets adds up to about $170 billion. That's equal to just 1.5 percent of global foreign exchange reserves.

Capital account opening looks like a high-risk strategy. Outstanding credit has swelled to more than 200 percent of GDP in 2015, from about 125 percent in 2008. A critical reason for confidence that tempestuous credit growth won't trigger a crisis is that a controlled capital account means borrowing is domestic and deposits are captive. A significant opening to cross-border flows would change that equation.

As for the AIIB, China's expertise in infrastructure development and deep pockets are a formidable combination. Even so, development loans by definition go to projects that are high risk and low return. As the World Bank and Asian Development Bank have found, those projects are difficult to manage. Starting from scratch, with rules still to be written and zero institutional knowledge, won't make it any easier for the AIIB.

In the background are concerns about China's growth. Bloomberg Economics believes that with far-reaching reforms, the economy could end the decade with growth still around 6 percent. That is not a universal view. Some analysts believe China is set to collapse under the weight of overcapacity and indebtedness. As Japan discovered in the 1990s, when growth ends, global influence goes with it.

The U.S. overtook the U.K. as the world's main economic engine at the end of the 19th century. It wasn't until the creation of the Bretton Woods system after World War II that it emerged as the main power in the International Monetary Fund, with the dollar anchoring the global financial system. China's symbolic rise has been breathtaking. It may be a while before its substantial position catches up.
CONTRIBUTORS

Tom Orlik is Bloomberg's chief Asia economist, based in Beijing. He was previously chief China economics correspondent for The Wall Street Journal, China economist for Stone & McCarthy Research Associates and a policy analyst at the British Treasury. He is the author of Understanding China's Economic Indicators.

Tamara Henderson is a Ph.D economist with buy- as well as sell-side experience, covering G-3 economies and the emerging markets over a span of 25 years. She has focused on FX and rates strategy over the past 12 years and has accumulated a strong track record for her trade ideas. Previously, she was an economist with the International Monetary Fund. Tamara is a CFA charterholder and the author of 'Fixed Income Strategy: A Practitioner's Guide to Riding the Curve,' published by Wiley.

Fielding Chen is an economist for Bloomberg based in Hong Kong. He was previously a senior economist for Asia at Banco Bilbao Vizcaya Argentaria. He holds a Ph.D in economics from Georgia State University and a master's degree in finance from Xiamen University. Chen is a published author and was an instructor at Chinese University of Hong Kong Business School.

David Dollar is a senior fellow with the John L. Thornton China Center at Brookings and an expert on the Chinese economy. From 2009 to 2013, he was the U.S. Treasury Department’s economic and financial emissary to China. Previously, he worked at the World Bank for more than 20 years, including serving as country director for China and Mongolia.

CONTENTS

GETTING INTO THE SDR BASKET
Chances are good that China’s currency will be included in the IMF’s new Special Drawing Rights basket in January.
Page 4.

CHARTING THE YUAN’S RISE
While use of the yuan in global transactions continues to rise, barriers remain to more rapid progress.
Page 5.

YUAN TRADING RULES
Backtesting analysis yields the trading rules that top returns for the offshore yuan in the past three years.
Page 7.

LESSONS FROM EXPERIENCE
The AIIB can learn from the experiences of the World Bank, says David Dollar.
Page 8.

PAVING THE WAY FOR ASIA GROWTH
Improving infrastructure and boosting growth are among the potential benefits from AIIB investment.
Page 9.

TIMELINE
Bloomberg Economics tracks a decade of the yuan’s major milestones.
Page 10.

To see Bloomberg Intelligence economists’ real-time economic analysis VISIT: NI ECOCOM
Achieving SDR Status for 2016: China May Get the Yuan Into the IMF's Basket

There is a real chance that remaining hurdles for the Chinese yuan can be cleared before the International Monetary Fund's new SDR basket is implemented on Jan. 1. IMF Managing Director Christine Lagarde signaled last month there was still a lot of ground to cover. The issue is whether CNY has become sufficiently usable in the five years since the last formal review of the organization’s Special Drawing Rights.

The SDR is an international reserve asset created by the IMF. SDR value is based on a basket of selected currencies determined by the Fund to be “freely usable.” These currencies are currently the U.S. dollar, euro, yen and pound.

During the last review of the SDR basket in 2010, the IMF rejected the yuan because the currency was not “freely usable.” The political backdrop was also against China. CNY trade settlement volumes were low and very one-sided, putting further upward pressure on the country’s already enormous international reserves. IMF staff considered the yuan substantially undervalued and the real effective exchange rate was depreciating.

Today, the yuan is much more usable (see trends mapped out in Charting the Yuan) and IMF politics are more supportive. In particular, more than 30 central banks are believed to have already begun reserve diversification into yuan. China also widened the yuan’s trading band and CNY valuation has improved. The Fund’s most recent Article IV assessment in 2014 noted the yuan had appreciated in real effective terms consistent with underlying fundamentals, though not enough to eliminate what was characterized as a more “moderate undervaluation” between 5 percent and 10 percent.

The yuan need not become fully convertible to satisfy the Fund’s SDR requirement that a currency be “freely usable.” According to the Articles of Agreement of the IMF (Article XXX), the yuan need only be “widely used to make payments for international transactions” and “widely traded in the principal exchange markets.”

The IMF also has some wiggle room in its assessment of usability. The Fund’s Executive Board said in 2010 that indicators should not be used “mechanistically” and that “ultimately, the determination of free usability would need to rely importantly on judgment, framed by the definition of freely usable currency set out in the Articles of Agreement.”

The issue is no longer whether the yuan is an international reserve currency, but the extent to which it is a major player. One indicator of progress: the notional value of onshore yuan options contracts cleared by the Depository Trust and Clearing Corporation from week to week usually rivals those for the yen.

At the same time, the yuan is not there yet in terms of daily turnover in the currency markets. Yuan turnover is 2.2 percent of the total compared with 2.5 percent for the Mexican peso, 4.6 percent for the Canadian dollar, 5.2 percent for the Swiss franc, 8.6 percent for the Australian dollar and 11.8 percent for the British pound, according to the latest BIS survey for 2013. The difference here is related to currency convertibility, which is critical for the high-frequency trading that China has so far steered clear of. Still, China’s share of SWIFT transactions is generally rivals those for the yen.

The Fund could also adopt a more congenial tone in the IMF’s Article IV assessment for China due this year. These could all be signals of CNY’s shift to SDR status in January.
Rise of the Yuan as an International Currency

Use of China’s currency in trade and foreign exchange transactions continues to rise. Limited foreign access to the mainland’s markets remains a barrier to more rapid progress.

Trade Settlement

As the world’s largest exporter, China has a natural advantage when it comes to raising the importance of the yuan in trade settlement. The data shows 1.65 trillion yuan of China’s imports and exports were settled in yuan in the first quarter, unchanged from the same period a year earlier. That’s equal to about 30 percent of total trade.

Global Payments

China’s share of total payments processed on the Swift network continues to edge up. As of February 2015, the yuan made up 1.8 percent of total payments, up from 1.4 percent a year ago. The yuan is the seventh most used global currency, fractionally behind the Canadian dollar and the Swiss franc.

BIS FX Transactions

The Bank for International Settlements data on FX market turnover provides a more comprehensive read on the yuan’s global position. Unfortunately, the BIS review is carried out only once every three years. The latest data, from 2013, shows the yuan in ninth place with 2.2 percent of global turnover. Based on the Swift payments data, its ranking has likely improved a little since then.

Bid-Ask Spreads

Bid-ask spreads in currency markets provide a more high-frequency reading on the yuan’s relative position. A tight bid-ask spread suggests strong liquidity and trading activity. On that basis, the yuan’s position remains some way off that of the euro, yen and sterling. Bid-ask spreads so far in 2015 have averaged 0.03 percent and 0.05 percent in the onshore and offshore yuan markets, respectively, compared with 0.01 percent for the euro, yen and sterling.

Continued on next page…
CHARTING THE YUAN...

Continued from previous page...

Dim Sum Bond Issuance
The People’s Bank of China continues to come up with ingenious workarounds to promote yuan internationalization without capital-account opening. Rapid growth of the dim sum bond market means international investors don’t need to bring funds into China to buy yuan assets. Offshore yuan bond issuance rocketed to 270 billion yuan in 2014, up 153 percent from 107 billion yuan in 2013. Issuance has slowed this year as offshore yuan rates have risen and access to the mainland market increased.

Bilateral Agreements
Swap agreements totaling 3.5 trillion yuan have now been signed between the PBOC and more than 30 other central banks. Currency swaps can be used by trade partners to cushion against a balance of payment crisis. As such, they reduce other central banks’ need for dollars and mean the yuan is already playing a role as a de facto reserve currency.

Hong Kong-Shanghai Exchange
The start of Mutual Market Access between Shanghai and Hong Kong equity markets last year represented a step toward market opening. So far, its reception has been lukewarm, with more than 50 percent of the inbound quota and 70 percent of the outbound still unused.

QFII and RQFII
Despite its progress, the scope for the yuan to emerge as a reserve currency remains limited by controls on access to the mainland markets. Adding up the quotas under the Qualified Foreign Institutional Investor, Renminbi Qualified Foreign Institutional Investor and Mutual Market Access schemes, foreigners can bring a total of about $170 billion into China’s markets. By way of comparison, global FX reserves are about $11.6 trillion.
Moving Average Rules Top Yuan Returns Since China's Trading Band Widening

Moving average rules have been generating more and more consistent returns for the onshore and offshore Chinese yuan during the past three years. The outperformance coincides with the widening of the daily trading band from plus or minus 0.5 percent of China’s daily central parity rate against the U.S. dollar to 1 percent in April 2012 and 2 percent in March 2014. The Accumulation Distribution Oscillator and Ichimoku signals also performed well within the group of strategies included in Bloomberg’s back-testing function (BTST<GO>).

Since the yuan trading band has been plus or minus 2 percent of the daily fixing, the Accumulation Distribution Oscillator has earned the highest return for CNHUSD, 4.1 percent. The Simple Moving Average rule was the top strategy for CNYUSD, earning 3 percent.

SMA has been one of the top three performing rules for both currency pairs since April 2012. SMA has earned 1.9 percent for CNHUSD and 3 percent for CNYUSD during the latest period, with the band at plus or minus 2 percent — compared with losses for the Buy & Hold rule. SMA earned 6.2 percent for CNHUSD and CNYUSD when the trading band was 1 percent either side of parity, compared with earnings of 2.4 percent and 2.5 percent, respectively, for Buy & Hold.

Weighted MA, Triangular MA and Exponential MA rules have outperformed Buy & Hold strategies by a margin of at least 1.4 percentage points since April 2012.

Between August 2010 and April 15, 2012, when the trading band was plus or minus 0.5 percent, Buy & Hold outperformed. Rules that earned profits for the offshore yuan often generated losses for the onshore yuan, and vice versa. Since April 2012, winning rules for the offshore yuan have also tended to be profitable for the onshore yuan.

Moving average rules can be more effective in established trends, while oscillators are designed to signal turning points. Oscillators might send false signals in a moving market, while trend-following indicators may underperform in a stable market.
LESSONS FROM EXPERIENCE  
GUEST COMMENTARY BY DAVID DOLLAR, BROOKINGS INSTITUTION

Lessons for the AIIB From the Experience of the World Bank

To understand the impetus for launching the Asian Infrastructure Investment Bank, look no further than China’s concern that the governance structure of existing international financial institutions was evolving too slowly. An important agreement to increase the resources of the International Monetary Fund and to raise the voting shares of fast-growing emerging markets, ratified by other nations, has been stalled in the U.S. Congress. It is ironic that one of China’s frustrations with the U.S.-dominated institutions is that China sees a need for more resources and is willing to contribute, whereas the different parts of the U.S. government cannot agree to this expansion.

China’s frustration is not just about the size of the institutions and its weight within them. In the case of the World Bank, China has argued for years for more focus on infrastructure and growth.

Several years ago, Ernesto Zedillo, former President of Mexico, chaired a “High-Level Commission on Modernization of World Bank Group Governance.” This was a serious effort by a distinguished international committee, including Zhou Xiaochuan from China and other emerging market heavyweights. The Zedillo report is quite critical of the current World Bank arrangement of a resident board that approves all loans. The resident board is both a large financial cost to the bank ($70 million per year) and an extra layer of management that slows down project preparation and makes the bank less efficient. Slowness of project preparation is one of the main criticisms of clients concerning the poor performance of the multilateral development banks.

The Chinese officials charged with developing AIIB are looking at the Zedillo report for ideas. It is likely that the bank will have a non-resident board that meets periodically in Beijing and also by videoconference. Given the newness of the bank, a likely compromise among the countries that have signed up is that the board will approve many of the initial projects and eventually delegate more decision-making to management.

The Zedillo report recognizes the importance of environmental and social safeguards but argues that the World Bank has become so risk averse that the implementation of these policies imposes an unnecessary burden on borrowing countries. In practice, developing countries have moved away from using existing banks.

The initial success of AIIB is a diplomatic victory for China. The U.S. diplomatic response has not been adroit, playing into the narrative of U.S. decline in the Asia-Pacific. But that perception could change quickly. Infrastructure is the “hardware” of economic integration, which is certainly necessary. But trade agreements such as the Trans-Pacific Partnership are the “software.” If the U.S. and its partners can negotiate and implement this agreement for deeper integration, that will provide a large boost for the members and reestablish U.S. importance to the Asia-Pacific economy.

China pursuing AIIB and other initiatives that do not include the U.S., while the TPP negotiations do not involve China, creates a risk of competing blocs and institutions. In my view, though, the most likely outcome is the world ends up with a more robust and inclusive set of institutions. AIIB is likely to make the other development banks more effective and become a part of the global architecture. China and other Asian countries not now involved in TPP are likely to join if it is successful. Bringing the hardware and the software together, the outcome could be a more integrated Asia-Pacific economy.

"The idea that AIIB projects would help absorb China’s over-capacity problem does not make any sense at all."
China's New Development Bank Aims to Clear Underbrush From Asian Growth Track

If it can overcome operational and political challenges, the China-led Asian Infrastructure Investment Bank may reduce infrastructure bottlenecks and boost developing Asia's potential output by more than 1 percentage point. The AIIB is poised to emerge as Asia’s biggest investment-focused multinational development bank.

Though it’s the world’s fastest growing region, developing Asia remains impeded by rusting and inadequate transport, power and communications networks. AIIB resources will be targeted at remedying that situation. The bank will probably launch by the end of the year and has attracted interest from 57 nations worldwide.

World Bank data show a big gap between infrastructure in Asia and developed countries. Compared with India's 2.3 telephone lines per 100 people, the U.S. has 42.2. While Indonesia has 1.3 fixed broadband Internet subscribers per 100 people, the U.S. has 29.3. The least-developed Asian countries have even bigger disparities.

Asia may need about $750 billion per year from now until 2020 to finance projects in transportation, energy supply, water facilities and other areas, according to the Asian Development Bank. A business taskforce reporting to the G20 forecasts that a third to a fourth of infrastructure investment needs in the coming 15 years may find difficulty in getting financing.

The AIIB would be well positioned to reduce that shortfall. The bank’s initial subscribed capital will be at least $50 billion and is expected to rise to $100 billion. Its paid-in capital is 20 percent of its total subscribed capital, or about $20 billion. Callable capital makes up the remaining 80 percent. While the World Bank and the Asian Development Bank have higher subscribed capital of $233 billion and $162.8 billion, respectively, they have lower paid-in capital — at $14.4 billion and $8.2 billion.

What sets the AIIB apart is its focus on infrastructure. The ADB committed about 60 percent of its $21 billion in new loans in 2013 to infrastructure projects, or about $12.6 billion. Given the AIIB’s sole focus on infrastructure, its capacity to make loans toward building Asia’s bridges and power plants might be 60 percent to 70 percent greater than its Manila-based rival’s.

The result may be a boost to infrastructure investment in non-China developing Asia of up to 0.5 percent of GDP a year. Long term, that may boost potential GDP in these countries by 1 to 1.5 percentage points. According to the IMF, a 1 percentage point increase in infrastructure investment as a proportion of GDP can raise annual output by 2-to-3 percentage points long term.

Development finance is not easy, even with major resources. Development institutions must take on projects almost by definition too risky for the private sector. The AIIB will take time to tackle questions about governance and funding as it ramps up to full capacity. Political concerns and overlap with other institutions are also barriers to rapid progress.

Still, China’s record of infrastructure development, the AIIB’s ample resources, and evident investment need across the region mean there are both motive and opportunity to make a difference. In an optimistic scenario, the AIIB’s position as a regional investment hub could drastically reduce Asia’s infrastructure shortfalls and anchor future development.
TIMELINE

TOM ORLIK, BLOOMBERG ECONOMIST, AND JENNIFER BERNSTEIN, BLOOMBERG BRIEF EDITOR

+ July (2005)
  China breaks the yuan’s peg from the dollar

+ Sept. (2005)
  U.S. Treasury accuses IMF of being “asleep at wheel” for allowing China to maintain an undervalued currency

+ June (2007)
  IMF decision on bilateral surveillance over members’ policies contributes to frosty relations with Beijing

+ July (2007)
  China Development Bank issues the first dim sum bond

+ June (2009)
  PBOC launches the yuan trade settlement pilot project

+ June (2009)
  HSBC is the first foreign financial institution to issue a dim sum bond

+ April (2008)
  Global financial crisis prompts China to repeg yuan to dollar

+ March (2010)
  Launch of Chiang Mai multilateral currency swap arrangement, drawing on a pool of $120 billion

+ June (2010)
  Yuan appreciation resumes after almost two-year peg to dollar

+ July (2010)
  Hopewell Highway Infrastructure issues the first corporate dim sum bond

  McDonald’s is the first multinational corporation to issue a dim sum bond

  IMF quota reform expands China’s share to 6.4 percent, from 3.7 percent

+ Aug. (2011)
  Remnminbi Qualified Foreign Institutional Investors scheme allows foreign holders of yuan to invest in mainland markets

+ Dec. (2011)
  NDF market expands to $300 billion

+ March (2013)
  BRICs leaders agree on establishment of new development bank

+ May (2012)
  Chiang Mai Initiative pool expands to $240 billion

+ April (2012)
  Yuan trading band doubles to 1 percent from 0.5 percent

+ June (2013)
  Bank of England becomes the 20th central bank to sign a currency swap with the PBOC

+ Sept. (2013)
  Shanghai Free Trade Zone established as a test ground for financial reforms, with easier rules on FX transactions

+ March (2014)
  PBOC widens yuan trading band to 2 percent from 1 percent

+ Oct. (2014)
  China starts process to establish Asian Infrastructure Investment Bank, quickly attracting a founding membership of 57 including U.K. and Germany

+ Nov. (2014)
  Launch of Shanghai Hong Kong connect, to allow cross-border investment in equity markets between the two financial centers

+ April (2015)
  IMF Managing Director Christine Lagarde says China’s financial reforms are “very positive steps” to including the yuan in the SDR basket

  Deputy director of the IMF’s Asia Pacific Department, Markus Rodlauer, says the yuan is reaching a point where it is close to “no longer being undervalued”

+ March (2015)
  PBOC Governor Zhou Xiaochuan says China is ready for IMF review of SDR, and the country will relax rules on outbound investment by individuals

  U.S. Treasury Secretary Jacob Lew says China needs to loosen its financial controls before the yuan can qualify to be included in the SDR basket

See what’s new, what’s changed and what we expect today
Take your free trial to Bloomberg Brief newsletters today!

The newsletters pull together the reporting, insight and analysis of over 45 senior editorial staff and dedicated economists to help you stay informed and ready for your daily business needs. They also offer cutting-edge access to proprietary Bloomberg data and breaking stories that move markets. With more than 20 titles to choose from, Bloomberg newsletters are uniquely positioned to provide you with the scope, depth and market intelligence you need.

<table>
<thead>
<tr>
<th>Economics</th>
<th>Leveraged Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economics Asia</td>
<td>Mergers</td>
</tr>
<tr>
<td>Economics Europe</td>
<td>Municipal Market</td>
</tr>
<tr>
<td>Asia Corporate Treasury</td>
<td>Oil Buyer’s Guide</td>
</tr>
<tr>
<td>Bankruptcy &amp; Restructuring</td>
<td>Pipes &amp; Wires</td>
</tr>
<tr>
<td>China</td>
<td>Private Equity</td>
</tr>
<tr>
<td>Clean Energy &amp; Carbon</td>
<td>Real Estate</td>
</tr>
<tr>
<td>ETFs</td>
<td>Structured Notes</td>
</tr>
<tr>
<td>Financial Regulation</td>
<td>Technical Strategies</td>
</tr>
<tr>
<td>Hedge Funds</td>
<td>Deutschland (free brief)</td>
</tr>
<tr>
<td>Hedge Funds Europe</td>
<td>London (free brief)</td>
</tr>
<tr>
<td>Latin America</td>
<td>Reserve (free brief)</td>
</tr>
</tbody>
</table>

88% of readers say their Brief helps them do their jobs better.

To set up your free 30 day trial:
Visit www.bloombergbriefs.com or call us on +1-212-617-9030 and we'd be happy to set you up. Ask about our group subscription savings too.

www.bloombergbriefs.com
Run **NI ECOCOM<GO>** on the Bloomberg Professional Service for real-time economic analysis and in-depth insight covering the U.S., Europe and Asia.

**PREVIEWs** help you prepare for major events or data releases. **NI ECOPREVIEW<GO>**

**REACTs** are fast takes on what the actions or numbers mean. **NI ECOREACT<GO>**

**INSIGHTs** dig deeper into macroeconomic trends and themes. **NI ECOINSIGHT<GO>**

Each commentary includes links to data and charts to help you take the analysis further.