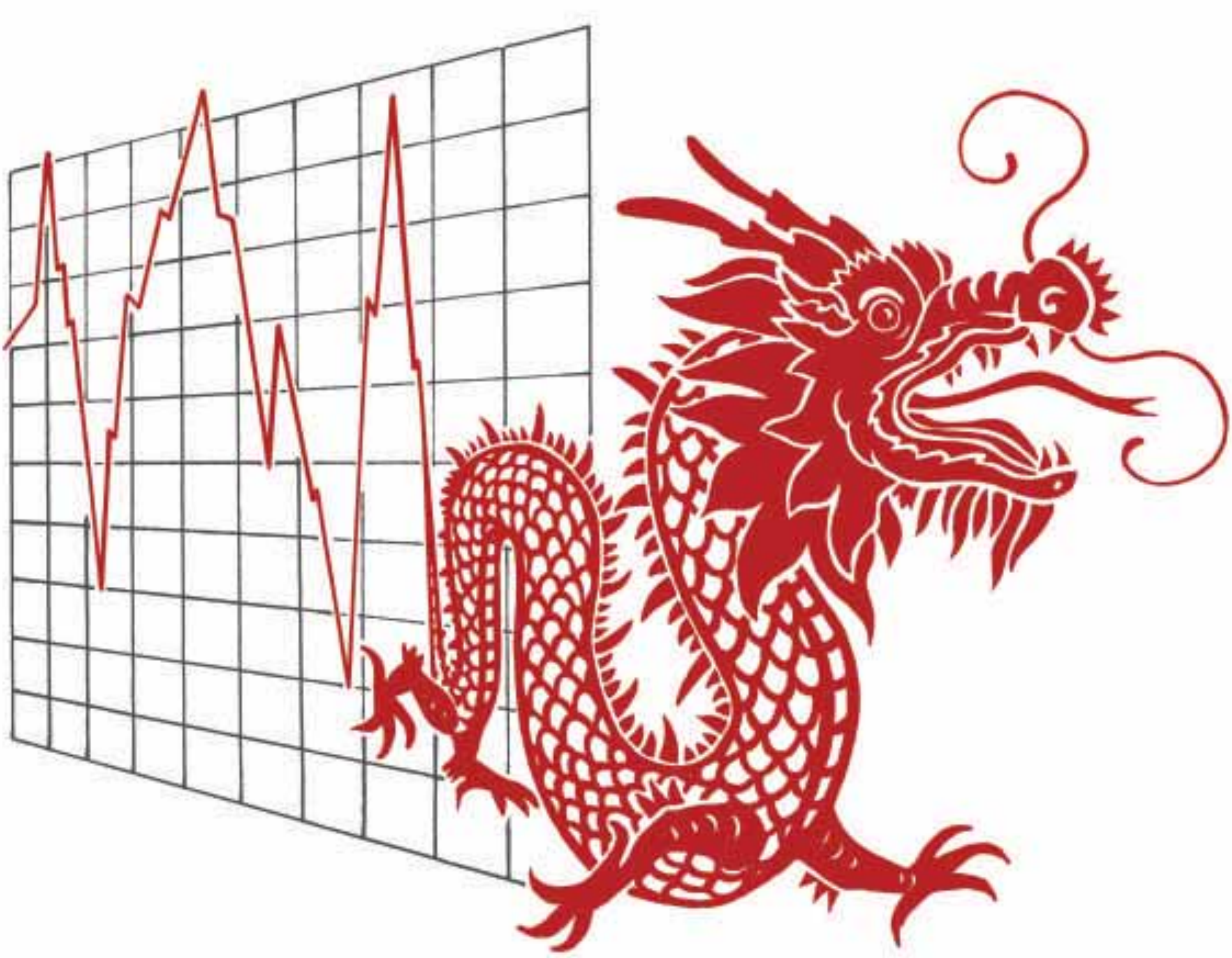
IPE
INVESTMENT & PENSIONS EUROPE
NOVEMBER 2015
ipe.com

How We Run Our Money
Sweden's Nobel Foundation

Emerging and frontier equities
COP21 and investors
Currency
Greece's private sector
Denmark's pension talent war



Special Report *The shift to China 3.0*

Special Report China

China's Big Bang

Timothy Van Housen and Joseph Mariathasan predict a radical liberalisation of financial markets and related regulations, with unprecedented investment opportunities

Financial Markets **Viewpoint**

This year's market volatility offered an all-you-can-eat buffet of China-related hype to market rhetoricians. But the real issues have been ignored. What is the macroeconomic set-up behind China's currency, current account, and monetary policies? What meaningful market and policy developments have already occurred and are in process? And what actionable investment opportunities are likely to result from all this?

Economists Robert Mundell and Marcus Fleming argued that an economy cannot simultaneously maintain all three policy objectives of an independent monetary policy, fixed exchange rates and a free capital account (the Mundell-Fleming Trilemma). In China's case, the decision to liberalise the capital account and the currency was taken in principle long ago, with the remaining question being only sequencing.

Instead, the major end-game will be the liberalisation and maturation of the domestic financial sector – China's Big Bang. Significant market and policy evolution has already occurred, which presaged tectonic shifts in the global investment management and credit sectors. This is the most important and most actionable investment thesis in China today. Together with the reform of state owned enterprises (SOEs), China's Big Bang will be the largest exogenous policy determinant of the amount, quality, and timing of future GDP.

We expect several events to occur in the final quarter of 2015 following the Communist Party of China's Central Committee Fifth Plenum and the implementation of other year-end economic policies. China is likely to simply float the currency, sooner and more comprehensively rather than later and less so; it will push forward the Big Bang reform of domestic finance with an aggressive further acceleration and a broadening of the domestic finance industry and financial market liberalisation; the currency float will be accompanied with a financial transaction tax of some kind (Tobin Tax) to dampen short-term speculative flows; the capital account itself is unlikely to open much further for now, and some tools will be retained to manage it.

At a glance

- **An aggressive liberalisation of China's financial institutions and financial markets is already under way and will accelerate, with historic opportunities for credit and investment management.**
- **China will float its currency with a transaction tax (Tobin tax) to deter speculation but will limit further capital account liberalisation for the time being.**
- **Recent market volatility and inevitable currency adjustments are of little consequence.**

International precedents

In their early stages of catch-up growth, both West Germany and Japan were slow to internationalise their currencies. How is China positioned? We know that China's currency exchange rate is fixed but the nature of capital account flows and the conduct of monetary policy have become ambiguous and are changing. While the capital account is nominally closed, the reality is that it is only partly managed and semi-porous. China's controls over capital flows have only ever been of limited effectiveness. It liberalised inbound foreign direct investment decades ago, gradually expanding the opening of domestic target sectors. During the mid-2000s, inflows surged on asset and currency speculation.

Then, in 2009, China embarked on its well-known renminbi internationalisation policy including significant expansion of foreign direct investment across numerous sectors, aggressive expansion of the renminbi for trade settlement, creation of the Offshore RMB (CNH) regimes, and expanding a multi-faceted alphabet soup of investment regimes, inward and outward. But renminbi arbitrage and the carry trade boomed, with rising global flows through the capital account. As a result, it had to engage in massive FX intervention, accompanied by massive sterilisation, as well as unusually frequent manipulation of reserves in the country's banking system.

The excessive use of government bonds and central bank bills, plus excessive re-engineering of the banking system's reserve requirements, have significantly distorted domestic credit markets, adding to pre-existing distortions inherent in an oligopolistic banking system dominated by state-owned banks. The costs of sterilisation go further – it effectively represents a subsidy to the export sector and to large state-owned enterprises (SOEs) at the expense of the rest of the economy.

As a result, China's monetary policy independence has only been achieved at high cost, as sterilisation policy resulting from the fixed currency regime has merged into and whipsawed monetary policy. More broadly, at a minimum, renminbi internationalisation and related global arbitrage activities will have certainly rendered domestic money supply far more unpredictable. Acordingly, with supply and demand for money rendered more unstable, this has added material difficulty to the traditional quantity-based monetary operation of the People's Bank of China (PBOC).

These worsening problems, arising from a crude juggling of the three variables of the Trilemma, further exacerbate other pre-existing resource misallocation and price distortions in the economy. There is a starkly bifurcated credit market, under which SOEs enjoy access to cheap capital while private SMEs are credit-starved. Rent-extracting market behaviour by certain very large monopolistic, upstream SOEs effectively taxes downstream supply chain private owned enterprises. The economic cost of this can be huge: in manufacturing, China suffers a 30-50% opportunity cost in total factor productivity just from resource misallocation.

Further liberalisation

For both China and the rest of the world, a superior outcome would be open currency and investment markets, removing misallocations and price distortions and significantly raising global real economic growth. The time has finally arrived to float the renminbi, albeit with some capital controls in place. This has been the approach of South Korea and Brazil, each with varying success.

A mature and functional finance industry, including functional capital markets, are a pre-requisite for successful currency and capital account liberalisation. The better financial markets work, the greater the benefits of liberalisation. A freely floated currency requires meaningful price signals to be reflected in a benchmark interest-rate curve, credit spreads, and foreign exchange crosses, both spot and forward, as well as in stocks and traded commodities. This all assumes mature financial institution balance sheets, intermediation mechanisms, and traded capital markets, with investors and issuers managing their balance sheets though this system.

Finance first

We predict an accelerated, full-scale liberalisation and development of the finance industry and financial markets in China. Finance liberalisation will get first billing because it is the predicate for future successful resolution of the currency and capital account, and so the enabler of monetary policy autonomy. This is one of the most significant private equity and credit investment propositions in recent years. Yet it has attracted only limited attention in financial media, board rooms, or the academic side of finance.

China's financial Big Bang has already commenced and its pace is accelerating. There are numerous important new sectors sporting annual growth rates from 20-30% up to 100-500% where there was no business as recently as three to six years ago in the absence of a licensing and regulatory framework. These include financial leasing, non-bank SME lending, consumer finance, hedge funds/alternative investment management (as private fund managers and segregated accounts), internet finance including peer-to-peer and financial product distribution, high-yield private credit securitisation, credit guarantee, agricultural/rural finance, non-bank distribution of investment products, and financial asset exchanges. Following the window of policy liberalisation, robust growth has come from pent-up, nascent underlying demand. Most sectors are wholly open to foreign investment. The scale of this development is unprecedented. What China has already accomplished in terms of its exports, urbanisation, and real estate development will now occur in finance.

"The historic impact of China's financial Big Bang has been lost in the rhetoric of speculation and hysteria about short-term market moves, which are of small consequence, to be expected in any developing economy"

China's Big Bang will involve a cornucopia of credit market and investment management opportunities. China's non-SOE corporates will become the largest credit-issuer base in the world. On a purchasing-power-parity-adjusted basis, the private SME sector is larger than that of Europe or the US, but is underdeveloped in credit issuance terms. The ratio of total liabilities to assets in the private SME sector is still only about 31% and fully half currently carry no debt on their balance sheets.

The household sector has the healthiest and least leveraged balance sheet of any large economy. If China's household sector were to leverage itself to the European average, the world today would not have an adequate global depository institution capital base to get the job done.

The household sector's observable domestic AUM of about RMB78trn (€11trn) is just beginning to open up to allocation to investment products at home and abroad, with 60% sitting in cash and deposits. The high-net-worth segment alone has over RMB25trn in observable domestic AUM. At recent growth rates, these assets should double in about five years.

The development of robust, private non-bank-finance (NBF) institutions and open markets is the solution for China. It has been in and through the SOE finance organs, including the big banks, where financial problems arise in China. The non-bank finance segment covers an enormous range of activities, licences and institutions. In a full programme of recent policy development, NBF licensing, companies, and products have been fully regulated, contrary to rhetorical hype about so-called 'shadow banking'.

Liberalisation appears self perpetuating. Both the success of renminbi liberalisation since 2009 plus the achievements in domestic finance liberalisation together require, and would allow for, liberalisation of the exchange rate. This can be expected to continue in fits and starts and at varying speeds. In time, a free-floating RMB and global activities of China's larger financial institutions will require significant opening of the capital account.

The historic impact of China's financial Big Bang has been lost in the rhetoric of speculation and hysteria about short-term market moves, which are of small consequence, to be expected in any developing economy, and are but a small part of an already established and understood framework. China's Big Bang will be the most important outcome of the events that are unfolding. Our further predictions of a currency float plus a Tobin tax and limited further capital account opening, are logical conclusions consistent with the forthcoming reform of domestic finance, the macroeconomic set up, and current policy trends.

Timothy Van Housen and Joseph Mariathasan are partners of Pangaea Finance Partners, which advises financial institutions in China