Ashmore

Bull in a China shop

By Jan Dehn

Introduction

Amidst yet another bout of fears about China's future, we set out our views on the outlook for growth, the financial system, China's public finances, reforms, and the country's external balances.

China is in the midst of a storming change. Interest rate liberalisation is coming as China prepares to let the bond market play an ever-greater role in macroeconomic policy.

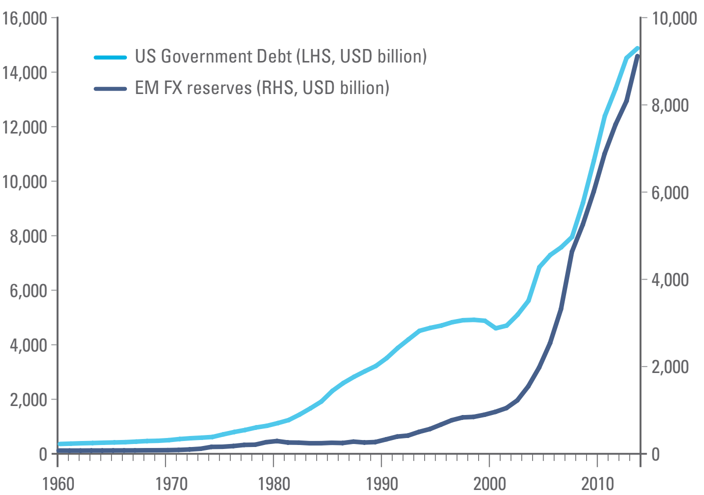
Why the need for change? In our view, the export-led growth model of the past few decades is no longer fit for purpose. As the largest holder of foreign exchange reserves in the world China will be more impacted by the unwinding of global imbalances than any other country. Political realities require dramatic change, quickly.

We think it is essential to look at China in a dynamic setting. Contrary to the current prevailing sentiment, we like China. We see a country facing up to the world of tomorrow, and adapting instead of merely languishing in denial that belongs to yesterday.

China and the US – a marriage slowly falling apart

Over the past thirty years one part of the world accumulated a lot of debt, while the other accumulated a lot of foreign exchange reserves. Emerging Markets (EM) accumulated reserves by selling goods to developed economies. They invested the reserves in the debt that fuelled the purchases of goods in developed economies in the first place. Nowhere was this intimate relationship between debtor and creditor closer than between the US and China. As of today, China has accumulated USD 3.8trn of FX reserves, or 33% of the world's combined stock of FX reserves, while the US has issued more debt than any country on earth – nearly 400% of GDP as of late 2013.

Fig 1: **A global imbalance**



Source: World Bank databank, US Treasury.

Europe and Japan of course also have enormous debts, but American debt is special for one reason only: It is denominated in Dollars, the world's dominant reserve currency.[1]

The reserve status of the Dollar confers onto the US one extra degree of freedom that other developed economies do not have. The US can pass the cost of reducing its debt burden onto foreigners by debasing its currency once inflation returns.

The crucial gamble facing China's leaders is this. Will the US use (or perhaps abuse) this privilege? If it does, it will impoverish China by eroding its stock of FX reserves and killing its export-led growth model, while it will enrich America by reducing its debts and increasing the competitiveness of its exporters.

The return of inflation threatens to wreck a 30-year marriage of convenience between the debt accumulator and reserve accumulator.

All change!

China's growth model until very recently was built on alternating bursts of export-led and investment-led growth. China switches from one to the other whenever production capacity constraints demands fresh capital spending. Strong demand from abroad was assured through a combination of active exchange rate management on the part of the Chinese and debt-fuelled consumption-led growth in Western economies.

But the prospect of a much stronger CNY and a sharp fall in the US dollar on the back of QE policies and high debt levels in the US means 'all change' for China's growth model.[2] Export-led growth has no future when debt-fuelled consumption in developed economies is over. Accumulating reserves is becoming more risky as exposure to US fixed income rises. The opportunity cost of

[1] Some 70% of global currency reserves are in US dollars.

[2] As we have discussed elsewhere, we think inflation and Dollar debasement will play a central role in the unwinding of the global imbalances – see *"A Pleasant Fiction"*, The Emerging View, September 2013.

accumulating reserves – in terms of forgone consumption – is becoming prohibitive as the need to shift towards domestic demand-led growth grows more urgent. Expanding the capacity to export further could lead to a dangerous misallocation of capital and the hard landing. Finally, China's ability to manage its own currency diminishes as developed economies turn to inflation to get rid of their debts.

If China does not turn away from the growth model of the past few decades soon there will be no growth model at all.

China's rapid pace of reform means it will be better placed to handle the world of tomorrow than most other countries.

Challenges of transition

Being more far sighted than most other countries on the planet, China already began to transition from export-led to domestic demand-led growth in 2011 with the launch of the latest Five Year Plan. The government reiterated its commitment to reform at the recently concluded Third Plenum in 2013.

But the challenges are formidable. Productivity has to be raised, because without greater productivity it is impossible to raise the level of domestic demand without creating excess domestic demand, that is, inflation and external deficits.

That is why China is so aggressively pursuing supply-side reforms the most important of which include: State Owned Enterprises (SOE) reform, interest rate liberalisation, land reform, reform of the Hukou system, and the easing of the one-child policy.

Market prices are also being given a far greater role in resource allocation – a crucial instrument for easing the passage of resources across sectors. Coordination of the reform process has been assigned to a senior group of policy makers (the Central Leading Reform Group).

On the other hand, transitions always run into both political and economic challenges. It helps that China is starting from a position of relative strength. Unlike most Western economies, China has spent the last few years removing many of the infrastructure constraints that often impede growth in other countries, an advantage that will become more apparent in the years ahead, when China will not run into some of the major capacity constraints that will hold back other countries.

The other piece of good news is that the political challenges to reform have largely been neutralised. The very public demise of Bo Xilai, a Party Secretary of Chongqing who strongly opposed change to China's export-led growth model, was a very clear signal to other opponents of reform to toe the new line, effectively sweeping away the conservative populist opposition to reform.

The bad news is that the economic challenges are larger and less easily overcome. Change causes uncertainty, which for a time depresses the appetite to invest. Growth invariably slows when resources move from one sector to another, particularly because the capacity of the newly favoured sectors to invest is typically lower than in the newly less favoured sectors. It is therefore no surprise that China's growth rates in the coming years will be lower than the growth rates since the early 1980s (which averaged 10% per year).

Slower growth also means lower inflation, so there is room for fiscal stimulus if required. But fiscal stimulus is no substitute for structural reforms, only a means of dulling the pain. China's soft landing is already well underway and will continue to be with us for some time to come.

From currency management to interest rate management

It is imperative for China's leaders – as for any leaders – to remain in power. In a country with per capita income ten times lower than the United States and lacking social safety nets means that staying in power boils down to delivering stability and steady high rates of growth. A pre-condition for delivering stability and steady high growth is that the government remains in effective control of the economy, so that it may avoid any shocks.

The currency will become less effective as a policy anchor going forward, because of foreign inflation and the rise of the consumer as the main driver of growth in China. By virtue of China's size, consumption will be dominated by non-tradable goods, which are relatively oblivious to the exchange rate.

The new policy instrument therefore has to be interest rates. And the main transmission mechanism for PBOC changes in interest rates onto the economy will be via the domestic yield curve. This means that the bond market will be front and centre in anything policy related in China going forward.

China's onshore bond markets are rapidly moving to the heart of policy making ahead of further capital account liberalisation.

The role of bond markets

In addition to acting as a transmission mechanism for monetary policy the bond market also serves three other important functions:

- Discipline local governments – the government is rotating away from local government financing vehicles and bank credit towards outright bond issuance at local government level. This will give markets a role alongside the central government in disciplining errant administrations by raising their borrowing costs
- Increase transparency – the experience from 2008/2009 showed that rapid credit expansion via local government financing vehicles can backfire. Issuance in public auctions is more transparent and therefore less risky
- Increasing consumption – China's savers are mainly confined to investing in stocks and property, but returns to both tend to be highly cyclical. Bonds have the wonderful feature that they rally when other assets fall. Bond markets will help to stabilise savings portfolios and thereby reduce precautionary savings rates. This helps to raise consumption

China's fixed income market is already one of the world's largest. The onshore market is worth USD 4.4trn comprising interbank loans, OTC bonds, exchange traded fixed income securities, and other types of fixed income. China wants this market to function more efficiently, which is why the government is expanding access for foreign dedicated institutional investors via the QFII and RQFII quota systems.

Opening the capital account

China will eventually abandon capital controls altogether, but capital account liberalisation is a risky business. Its success or otherwise depends on who comes knocking. In practice it can be difficult to police the entrants, and given the desire of the authorities for overall control we think the opening of China's capital account will continue to be gradual.

Ultimately, capital account opening will be a function of the extent to which China's leaders feel comfortable about their capacity to maintain stability in the onshore bond market. In other words, capital account liberalisation is likely to be closely linked to the development of the onshore bond market.

This means that China will continue to move forward with capital account liberalisation. The recent convergence of onshore, offshore and fixing exchange rates is part of the preparation. The gradual increase of domestic interest rates is part of the process. The decision to allow some domestic bonds and trust products to default is another facet of the process. The aforementioned extension of QFII and RQFII access to an audience of EM specialist asset managers beyond Hong Kong is also part of the process.

We think China's transition from an export to a domestic demand-led economy will be gradual but determined, ultimately placing China in a good position to weather the largest global macroeconomic dislocations that will play out over the next decade or so.

In the rest of this paper we address a number of more specific questions of immediate concern to some investors.

Are China's credit markets too large?

- Developing countries are poor because they have less capital per worker. But if there is a silver-lining to poverty it would be that each unit of capital in poor countries has a higher return. Capital should therefore flow from developed economies to Emerging Markets, bringing about what economists call economic convergence.
- Sadly, most EM countries are able to attract a very small share of global capital, in part because regulators in developed economies are doing everything they can to hold on to it (financial repression).
- China has managed to ease this capital constraint by sustaining very high savings rates. This naturally means that China's credit markets are also larger than those of other countries.
- Indeed, the ratio of total credit to GDP in China is about 230%, but with a deposit base of about 160% of GDP the leverage ratio in the banking system in China is actually very low compared to most developed economies (where savings rates are much lower and credit markets larger).
- As long as China maintains good macroeconomic policies with solid regulation we think a large credit market is an asset rather than a liability: China will be less constrained in its economic convergence than less credit-endowed EM economies.

Is China over-investing?

- Recurring fears of a hard landing in China are typically due to the view that China over-invests. If China misallocates capital it is only a question of time before the country discovers a mountain of bad debt.
- China is partly to blame for creating the impression of over-investment. Its own data shows that consumption rates are very low (sub-40% of GDP). But research produced by Standard Chartered Bank shows that official data is significantly understating consumption rates.[3]
- According to this research, Chinese consumption data does not include consumption of residential services, consumption of in-kind services extended by state employers, and consumption from unreported income.
- When consumption numbers are adjusted for these deficiencies the rate of consumption in China is closer to 50% of GDP, putting it in line with Asian economies at similar stages of development. Hard landing fears may therefore be severely exaggerated, in our view.

We are bullish about China despite natural challenges in rotating from export to domestic demand-led growth.

Do trust products post a systemic risk?

- What are trust loans?
  When ordinary people put money in the bank in China they have a choice. They can either opt to get paid the regular deposit rate of 3% or thereabouts, or they can opt to put their money into higher yielding 'wealth management products' (WMP) or 'investment trusts' that pay about 200-500 bps more in interest.[4] Trust loans are for the most part passive, unleveraged and regulated loans made by depositors directly to borrowers in the public or private corporate sector in China.
- Who is at risk if a trust investment fails to repay?
  Trust products are unambiguously more risky than ordinary deposits. They are exposed directly to more risky sectors and there are duration mismatches. Trust loans are not on the balance sheets of the banks, so they are not a direct bank liability. The bank merely acts as a broker between the depositor and the end-user of the funds. In theory, therefore, investors face all the risks. In a recent trust loan default, however, the bank did share in the loss, so in practice banks are not entirely free from liability.
- How big is the trust sector and how has the sector performed?
  Total deposits in China are roughly CNY 100trn, or 160% of GDP, and trust products are about CNY 10trn, or 16% of GDP. Trust products are generally simple structures with a good track record. They are also included in broad monetary aggregates, such as M1, M2, and Total Social Financing, and subject to reserve requirements. NPLs are running at about 1.5% and banks have made provisions for these loans amounting to about 300% of the current NPL rate.
- What is the government doing about the trust sector?
  Trust products exist due to a lack of alternatives; they are the consequence of an underdeveloped financial sector. The Chinese government is trying to deepen and broaden the financial sector to generate better alternatives for savers, including promoting the mutual fund industry to take over the business of the investment manager. Interest rate liberalisation will further reduce demand for trust loans as the bond markets become the basis for the asset management business in China. Eventually, the asset management industry will take over the bulk of direct term lending to corporates from the banks in China. There are also plans afoot to transfer the modest NPLs out of banks and into the mutual fund industry.
- Is the trust sector a source of systemic risk?
  No. Default rates are very low. But even in the extremely unlikely scenario where: (a) every single trust loan in China went bust; (b) recovery value on every single loan was zero; (c) banks were forced to bail out every trust loan creditor; and (d) the government in turn bailed out every single bank for every single loss on every single trust loan the cost to the government would be 16% of GDP. A loss of this size would take total public sector debt in China from 56% of GDP today to 72% of GDP. While this would be a big one-off increase in public debt it would still not make China's debt burden unsustainable.

[3] *"Masterclass – China is not really that imbalanced"*, Standard Chartered Bank, 24 September 2013.
[4] Traditional WMPs have a wide investor base, while investment trust products are placed with a narrower set of wealthy individuals or corporates.

We believe China's macroeconomic fundamentals remain among the most robust in the world.

Is China's public sector over-indebted?

- China's National Audit Office (NAO) recently published the findings of a root and branch review of China's public sector debt burden. The NAO's report showed that China's total government debt was 56% of GDP as at mid-2013 comprising local government debt of 33% of GDP and central government debt of 23% of GDP.
- By any standards these are manageable levels of public debt, especially taking into account China's high savings rate, high rates of real GDP growth, and strong external asset positions (FX reserves are nearly 40% of GDP).
- Within the overall debt numbers, local government debt is rising quickly (from 26.7% of GDP in 2010 to 33.2% of GDP in 2013). The government is already introducing measures to control local government debt issuance.
- We estimate that China's forward debt profile is extremely benign with total government debt set to decline towards 35% of GDP over the next 35 years, based on NAO's latest debt numbers and IMF's forecasts for China's fiscal balances.[5]

America's choices

At nearly 400% of GDP, America's stock of debt today is twice a large as before the big fall in the US dollar in the 1970s. Will the US repay this debt or inflate and devalue it away?

We think inflation and currency devaluation will play a major part, because the alternatives are either too unpalatable or simply infeasible. We estimate that:

1. The US economy would have to grow 10% per year in real terms for more than a decade to return the economy's overall debt burden to 200% of GDP (assuming a fiscal deficit of 3% of GDP, inflation of 2%, and nominal interest rates of 4.5%). If the economy only grows 2.5% at zero interest rates how fast can it grow under normal monetary conditions?
2. The US would have to run balanced budgets for 29 years to return the debt stock to 200% of GDP (assuming real GDP growth of 3% per year under 2% inflation and with nominal rates of 4.5%). Try that with voters.

This leaves financial repression, inflation and Dollar debasement, which all seem likely to play a major part in eroding America's debt overhang.

We expect inflation to begin to return when deleveraging is over by mid 2016. Normally, the Fed would then raise rates. But the Fed would risk crashing the mortgage and Treasury markets if it sells assets and the enormous stock of debt means that the economy is highly sensitive to even modest increases in real rates.

Inflation amidst low nominal bond yields pushing down real yields and weakening the Dollar. In the 1970s, the Deutschmark and the Japanese Yen rallied 50% against the Dollar. Today, the problem is twice as big and the big surplus economies are all in the EM world. China is the biggest of them all.

[5] Ashmore's *Weekly Investor Research*, 6 January 2014.

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