China’s Liquidity Management: A juggling and balancing act

Abstract – As the world is flooded with printed QE money, China’s own liquidity management, by comparison, entails more than just job creation and economic growth. Inflation control has reached top of the agenda to forestall a ballooning asset bubble. The hungry horde of the world’s top hedge funds are camped at the gate as international pressure is bearing on the Chinese yuan to appreciate so much and so quickly as threatens her very economic and social stability. Yet with an embarrassment of surplus savings invested in US treasuries, she is caught in a US Dollar Trap whose exit doors, if any, may not be readily available. How China manages this juggling and balancing act of liquidity management is as intriguing as game-changing, not just for China herself but for the rest of the world.

At a time when the consumption-driven West is busy pumping ever more liquidity into their economic systems through Quantitative Easing (QE), it is instructive to see how a bubble-and-inflation-prone China is coping with her own liquidity problems compounded by a tsunami of global funds hitting her shores.

As it were, the ‘barbarians’ are already at the gate. A lot of hedge funds, including Soros Fund Management, Altis Partners, Viking Global Investors, and Paulson & Co are entrenching themselves in Hong Kong, one of the world’s top three financial centres. The total hedge fund accumulated in Hong Kong is reported to reach HKD 500 billion (US$64 billion). Some have put the estimate much higher.

Indeed, in the wake of Jim Chanos, a leading ‘shorter’ of China, another reputable hedge fund manager Mark Hart of Corriente Advisors has just launched a fund betting on China’s coming credit implosion (1). He reckons that China has produced 200 million tons of excess steel and 3.3 billion square meters of excess floor space with extra 200 million square meters being added every year. There is a heady price-to-rent ratio of 39.4 times, compared with 22.8 times in the US just before the sub-prime crisis. Counting investments by Local Investment Companies
borrowing from China’s state-owned banks, non-cash producing assets would amount to 98% of total bank equity, and government debt to GDP would reach 107% or five times the official estimate, and may even be as high as 200%.

So ‘Is China the next Dubai’? This is the topic of a Paper I wrote in February this year which I used for a London evening debate on this very question with another ‘China-shorting’ contrarian investor (2). While allowing for China’s asset bubbles and inflationary pressures, the gist of my riposte was that invariably all of the analyses of the ‘shorters’ failed to take into account the most gigantic urbanization drive in the history of mankind. The scope and speed of China’s urbanization can only be glimpsed in a McKinsey Global Institute report dated March 2008 (3).

All the way to 2025, China is building 221 new cities (many in the inner provinces) with population over one million each, compared with only 35 cities of such size in the whole of Europe. Being added are 5 billion square meters of road, 170 mass transit systems, and 40 billion square meters of floor space in 5 million new buildings (including 50,000 skyscrapers or ten New York Cities).

Additionally, China already leads the world with 6,552 km of high-speed tracks for trains at speeds over 200 km/h. This high-speed network is expected to double in two years. Accordingly, spending on railroad construction has reached $120 billion this year, an 80% increase over 2008, and is expected to reach $700 billion over the next decade (4).

Such developments are part of infrastructure China needs to put in place if a 70% urbanization rate is to be achieved by 2030. This level of urbanization is needed to boost China’s domestic consumption to a similar percentage from its current level of only 36%. A more consumption-oriented economy will spawn a more balanced, sustainable
and ‘inclusive’ growth. Support this growth model will be the expansion of services from 42.6% to 50% of GDP, economic redistribution between the urban and rural sectors, welfare provisions, higher wages, industrial upgrading, innovation, and environmental and resource conservation. New policies are expected to be detailed in the forthcoming 12th Five Year Plan.

Most of the credit and resources required for these developments are provided by the Chinese state or state-owned banks and institutions not always beholden to commercial revenues. In the wake of the global financial crisis, China’s home-made credit creation has been growing at a rate of 17% annually, reaching over 17 trillion yuan. Because of the speed with which new infrastructures come into being, it is no surprise that initially, a great deal of them would appear empty or under-utilized, like Pudong in Shanghai or the Docklands in London when first built. What is more, the required credit creation, which initially took the form of a massive stimulus package in response to the global financial crisis, has been fuelling domestic inflation. The Consumer price index (CPI) jumped from 3.6 percent (y/y) in September to a 25-month high of 4.4 percent (y/y) in October, and from 7.1 percent (m/m annualized) to 8.6 percent over the same period. Food prices rose by 10.1 percent (y/y) and 20.1 percent (m/m, annualized) in October. Property prices in China’s 70 major cities have also been galloping, particularly from April 2009 to April 2010, pushing them to unaffordable levels and feeding into an enlarging housing bubble.

The World Bank revised its forecast (3 November, 2010) of China’s full year GDP growth to 10%. The official Purchasing Managers’ Index (PMI) in November 2010 registered a seven-month high of 55.2%. Much of the increase is attributable to increased prices of material inputs.
This is reflected in Producer Price Index (PPI) increases, translating into CPI inflation. The resultant social tensions have flagged up inflation control as a top national priority ahead of growth (5).

However, even as China’s exports have recently been picking up, her largest export markets in the EU and the US are still anemic with rising protectionism. This poses a serious threat to China’s jobs and hence social stability. As a large part of her infrastructural projects and indeed most of China’s economy require on-going and easy credit, any credit tightening to combat inflation cannot be pushed too far.

President Hu Jintao is reported to have said that the Mainland would shift from a ‘relatively loose’ to a ‘prudent’ monetary policy in 2011, seeking a balance between job-generating economic growth, adjustment of the economic structure and managing inflation (6).

During 2010, China has increased the banks’ capital reserve requirements five times. Additionally, on 20 October 2010, the People’s Bank of China announced an interest rate increase of 25 basis points, the first interest rate hike in nearly three years. Further mild interest hikes are expected in the coming year. Unlike Western economies, China’s propensity for consumer credit is extremely low. So the impact of these hikes on Chinese consumers is through higher interest-earning inducement rather than increased consumption borrowing cost. Nevertheless, it remains doubtful whether such mild hikes alone would achieve the objective of arresting inflationary pressures.

To rein in unbridled credit creation, China’s Banking Regulatory Commission has recently mandated that all off-balance sheet bank assets and liabilities must be brought on-balance sheet by the end of 2011. To regulate the property market, the government has introduced new
restrictions limiting credit access for more than two apartments per family, coupled with large-scale subsidized housing programs. Foreigners are now required to prove they have been local residents for at least one year before they can buy an apartment for their own use. But with more disposal income in a resurgent economy, the pent-up demand for new housing from a rapidly rising middle-class is unlikely to be significantly suppressed. Housing bubbles of various sizes may therefore remain a feature of China’s economy for some time.

Following successive Quantitative Easing (QE) in the West, hot money has been pouring into emerging markets to seek higher returns. In October 2010, foreign exchange inflows into Mainland China increased by 19.2% to some 510 billion yuan. On 9 November, China announced a series of measures to tighten the control of such inflows. These include more meticulous accounting, auditing, guidelines on foreign exchange credits and guarantees, cash transfers from FDI and offshore IPOs, creation of related offshore companies, and enforcement against irregular transactions. As a top international financial centre with low-tax and free capital markets not subject to any exchange controls, Hong Kong has become the world’s leading IPO centre, raising some 300 billion HKD. How some of these funds are remitted into the Mainland would be closely watched, as would the massive gathering of hedge funds in Hong Kong outlined earlier.

Mainland China itself, of course, has tight exchange control and the Chinese yuan is not internationally convertible. For example, as an individual Hong Kong citizen, I am allowed to convert a maxim of only 20,000 yuan per day into Hong Kong Dollars or vice versa.

Testing the waters for the yuan’s eventual convertibility when funds may be able to move freely in and out of China’s financial system, China has introduced two transitional mirror-image schemes to allow
regulated inflows and outflows of investment funds to and from the Mainland. Qualified Foreign Institutional Investors (QFII), launched in 2002, permits licensed foreign investors to buy and sell yuan-denominated "A" shares in China's mainland stock exchanges. As of February 2009, a total of 79 foreign institutional investors have been approved under the program. The Qualified Domestic Institutional Investor (QDII) scheme, announced in 2006, provides for licensed financial institutions to invest in offshore products such as securities and bonds, subject to an overall quota. On April 8, 2008, an agreement between the China Banking Regulatory Commission and the US Securities and Exchange Committee enabled Chinese individuals on the Mainland to invest in the US stock market. But a similar proposal for the Hong Kong market still remains on the cards.

Meanwhile, the door on the Mainland is left ajar for international private equity. Those in the world’s top league such as Carlyle, TPG, KKR and Blackstone, have all set up China-related operations. The Economist has reported (7) that there are now 167 registered foreign managers (and 265 domestic ones) of private equity funds in China, compared with none a decade ago. Since 2005, private equity has raised more than $57 billion for investment in China. Yet the experience has been mixed at best with too many firms chasing too few good deals. The usual buy-out techniques of dismemberment, leverage and tax avoidance are not practicable and there is a great deal of operational drudgery and restrictions.

But on China’s liquidity management, the biggest story is perhaps how she is going to get out of what Paul Krugman, New York Times op-ed columnist and Nobel Prize laureate, calls the ‘USD Trap’ (8).

China’s economy will remain in a transitional phase until her burgeoning middle class reaches 70% of the population along with a
similar urbanization rate, which is expected by 2030 (9). During the trajectory, China needs to generate some 20 million extra jobs every year to absorb her excess labour from the countryside. To be able to deliver these jobs on pain of social instability, she has to rely on manufacturing and exports, supported by a formidably efficient global production and supply chain and a competitive exchange rate. Pending the development of a middle-class consumer-driven economy, coupled with the continuing need of most of her population to save for rainy days, her surging export surpluses have turned into a mountain of savings. As China’s domestic financial and investment sector is less than well-developed, much of these savings are channeled from the state banking system into reasonably safe investments in US treasuries, creating a perennial low-interest rate environment spreading from the US to the rest of the world. Now, low interest rates are manna from heaven for Western economies as they boost consumerism and provide cheap finance for financial investments as well as allowing for politically-appealing tax cuts. Western consumers are thus able to buy more products from China as the world’s leading global manufacturer. So the cycle goes on. This way, China has built up a gold mountain of foreign exchange reserve to the tune of $2.65 trillion as of October 2010, out of which US treasuries account for $883.5 billion (10), making her the largest holder of these treasuries and the largest creditor of the United States. At the same time, she now finds herself in a US dollar trap from which she can’t extract herself too quickly without getting badly hurt first by a collapsing US Dollar.

But the operative words are ‘too quickly’. It is in China’s interest to try to wriggle out of the trap and change or at least modify the rules of the game now stacked against her. The first warning shot was fired by China’s central bank governor Zhou Xiaochuan in an article days before the London G20 summit on 23 March 2009 (11). He calls for replacing
the dollar as the dominant world currency with a more stable international reserve currency that is disconnected from currency-issuing nations’ own narrow national interests. Using the Special Drawing Rights of the IMF is proposed as a good start. He draws attention to the so-called Triffin Dilemma (12) i.e., issuing countries of reserve currencies cannot maintain the value of the reserve currencies while providing liquidity to the world. This has generated some degree of international support (13) and considerable controversy.

That was just talk. However, in recent months we are witnessing an exit strategy, which have been picked up by various think-tanks and investment research houses (14).

First, in December 2009, foreign-held US treasuries dropped by $53 billion, of which $32.4 was due to China’s withdrawal, signaling a possible incremental diversification out of the US Dollar.

Second, China is allowing a gradual appreciation of the yuan over a fairly long timeline. Too rapid and appreciation will not only spark speculation and confusion but, as export margins are already wafer-thin, this will wipe out millions of jobs on the Mainland causing massive social instability. While by no means adequate or accepted in response to the more strident calls for a one-off huge appreciation, a more measured appreciation is ‘do-able’ by way of showing China’s accommodating efforts. In any case, yuan appreciation is inevitable as more purchasing power is needed in the hands of her masses as a boost for consumption. Appreciation will reduce her trade surpluses in the long-term and help achieve a more balanced economy. This would also enable her increasingly out-going capital, including large state-owned enterprises and her sovereign wealth funds such as the China Investment Corporation (CIC) and their proxies, to acquire more equity, assets, and much needed resources in the global market-place. Such outward investments are already taking place across the globe.
Third, and more importantly, China cannot play a more influential part in changing the existing rules of the game to achieve a more sustainable international currency system unless the yuan becomes fully convertible. But she needs time, experience and expertise in building a more robust financial system able to withstand the often disruptive vagaries of free flow of funds in and out of the country. Meanwhile, she is promoting greater international recognition and acceptability of the yuan as a means of international settlements, particularly amongst her South East Asian trade partners whose economies are at any rate already intermeshed with China’s global production chains. Since late 2008, she has also signed currency swap agreements with Singapore, the Republic of Korea (ROK), Hong Kong, Malaysia, Belarus, Indonesia, Argentina and Iceland. More recently, China has been issuing more and more yuan-denominated bonds, using Hong Kong as an international launching pad. At a time when most of the world’s currencies are shaky, an upward-appreciating yuan underpinned by a vibrant economy has obvious attractions.

So, China’s liquidity management is a dazzling and precarious juggling-cum-balancing act. As she is at the heart of globalization when the sands on the ground are shifting from the West to the East, whether her performance succeeds or stumbles will affect not only the well-being of China’s huge population but also the rest of the world. This space will surely continue to be closely watched.


(6) Beijing moves to put a lid on inflation, Cary Huang in Beijing, South China Morning Post, 4 December 2010, at http://www.scmp.com/portal/site/SCMP/menuitem.2af62ecb329d3d7733492d9253a0a0a0/?vgnextoid=63a9e01bd1dac210VgnVCM100000360a0a0RCRD&ss=Companies+%26+Finance&ss=Business (accessed on 4 December 2010).

(7) Barbarians in love, Private Equity in China, The Economist, 27 November 2010


(9) See (3) above.


(12) This dilemma was first identified by Belgian-American economist Robert Triffin in the 1960s. He opined that global reserve currency-issuing countries have to suffer large trade deficits in order to supply the world with enough of its currency to fulfill the world demand for foreign exchange reserves. This leads to a conflict of interests as well as tension between national monetary policy and global monetary policy.

(13) Such support included Benn Steil, Director of International Economics, US Council of Foreign Relations; Joseph Stiglitz, Nobel Prize laureate and head of UN Panel; Jeffrey Sachs, Professor of...
Columbia University and Special Advisor to UN Secretary-General; Dominique Strauss-Kahn, Managing Director, IMF; out-going Brazilian President Lula da Silva and a Russian Presidential aide.

(14) Such as *China: Three Ways out of US Treasuries*, Asian Economic Weekly, Nomura Global Economics, 5 March 2009; *China tries to wriggle out of the US Dollar trap* in Yale Global on 29 April, 2009 by Wenran Jiang, Mactaggart Research Chair and Associate Professor of Political Science at the University of Alberta and a senior fellow at the Asia Pacific Foundation of Canada; *Is China ready to challenge the Dollar?*, a report of the CSIS Freeman Chair in Chinese Studies, Centre for Strategic and International Studies, Washington DC, October, 2009.

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**Positions**

Chairman and CEO, Andrew Leung International Consultants Limited, London
Gerson Lehrman Group (Global Experts) Council Member
International Expert, Reuters Insight Community of Experts, Thompson Reuters
Brain Trust Member, The Evian Group (global think-tank), Lausanne, Switzerland
Distinguished Contributor, Asymmetric Threats Contingency Alliance (ATCA) (global think-tank)
Elected Member, Royal Society for Asian Affairs
Senior Consultant, MEC International
Global Commercial Agent, Changsha City, China
Visiting Professor, London Metropolitan University Business School
Visiting Professor, Sun Yat-sen University Business School, China (2005-10)

(*The following until 19 May 2010, on permanent relocation back to Hong Kong*)

Founding Chairman, China Group, Institute of Directors City Branch, London, UK
Vice Chairman, 48 Group Club, UK
China Group Leader, Elected Fellow on Executive Committee of Royal Society for the Encouragement of Arts, Manufactures and Commerce (RSA), London Region
Governing Council Member, King’s College London, UK
Advisory Board Member, China Policy Institute, Nottingham University, UK

Included in UK’s Who’s Who since 2002
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