

China Joins the Capitalist Club in the Age of Turbulence

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A financial world without borders

- Climbing the **Value Chain** :Made in China – Made by China (Brands) – Owned by China
- Dramatic build-up of **FX Reserve** (US\$1.41 trillion + ~ 20% p.a.)
- **China/US financial imbalance**
- **Interest rates** connect globalised economies, money flows and currencies
(Differentials narrowing (Fed, ECB, BoE, and even BoC?))
- **Borderless Stock Exchanges** (NYSE + Euronext; Nasdaq + Dubai (+ OMX (Stockholm)) + LSE v Qatar (+ OMX) + LSE; Shanghai + HK possible?)
- **China's underdeveloped financial system** (*Mckinsey Quarterly, 2006*)

% GDP & Corporate Lending (2003)

	SOE	State shareholding	Collectives	Private Enterprises
GDP	23	19	6	52
Lending	35	27	11	27

Components of financial stock % (2004)

	Bank deposits	Govt Debt	Corporate Debt	Equity
US	19	12	35	34
China	72	5	8	15

Equity capitalization % GDP (2004)

US	139
China	17

Corporate Debt % GDP (2004)

US	145
China	1

From the Industrialist to the Capitalist Club

- **3(4) of world's top 5(10) corporations** (market cap) - *PetroChina (US\$1T 2 x ExxonMobile), ICBC (World's largest bank), ChinaMobile, Sinopec*
- **Massive IPOs** - *BoC (US\$9.7 b), ICBC (US\$21.9b), Alibaba (US\$1.5 b, largest internet IPO since Google)*
- **Booming M & A - Mainland** - US\$ 29.4b in first 3Q 2007 **Outbound** - *CNOOC for UNOCAL, Nanjing Motor Group for MG Rover, CIC 10% in Blackstone, CDB 3.1% in Barclays, CCB for B of A's HK & Macao operations, China Minsheng 9.9% of UCBH (US bank), ICBC 20% of South Africa's Standard Bank, ChemChina + Blackstone for Nufarm (Australian agro-business), CITIC 6% Bear Stearns, CDB <1% in Rio Tinto.*
- **China to grow yuan private equity** – *Wu Xiaoling, Deputy Governor, PBoC, 2007 China M & Annual Conference, Tianjin*
- **Imminent launch of stock index futures** – *hotbed for hedge funds already on Mainland by stealth e.g. trade settlements, property and Chinese stocks, betting on RMB, Asian hedge funds= US\$ 20-50b*
- **4 of Big 5 SCBs** (60% of all loans and deposits) embrace **foreign equity**: *HSBC 19.9% of BoCom (2004); BoA 10% of CCB, RBS 10% of BoC; Goldman Sachs 10% ICBC (2005)*
- **Local incorporation of foreign banks** – *Citibank, HSBC, SCB, BEA*
- **Controlled outflow** *Estimated US\$10b (Deutsche Bank), 23.4b (Morgan Stanley), 690 b (+80%)(Lehman Brothers), (US\$4,800 b household and corporate savings)*
 - *Liberalised QDII - banks allowed 50% overseas investment quota for approved equity funds*
 - *US\$6.6 b raised in Beijing in one day (Sept, 2007) for an overseas equity fund*
 - *Chinese citizens with a/c at the BoC Tianjin to invest in HK stock market*
- **China Investment Corporation (CIC)** *to manage initially US\$200b of FX*

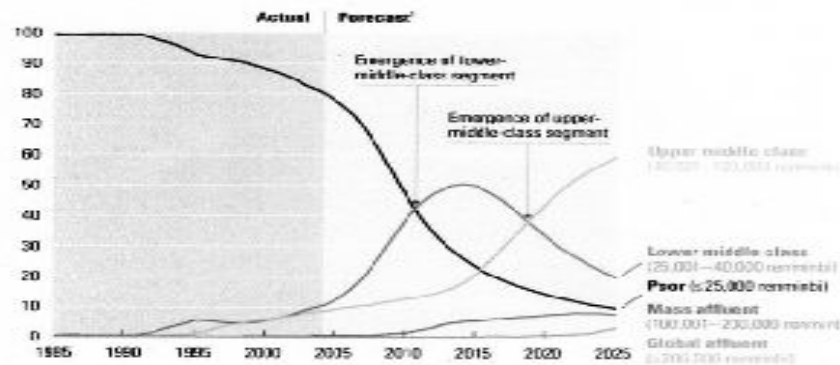
From Savers to Consumers

The emergence of China's middle-class

(McKinsey Quarterly, 2006)

The emergence of a middle class

Share of urban households by income class, %

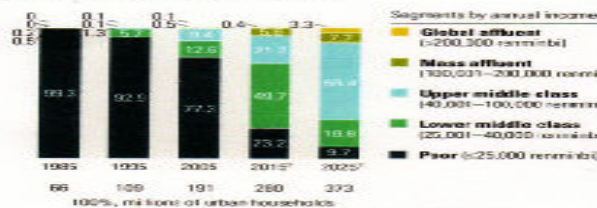


¹ Base case forecast, Q1 2006.

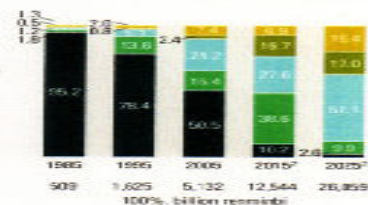
Source: National Bureau of Statistics of China; McKinsey Global Institute analysis.

Spending power is on the rise

Share of Chinese urban households, %



Share of total urban disposable income, %



¹ Some figures do not sum to 100% because of rounding; disposable income = after-tax income, including savings real reinvested.

Base year = 2005; 1 RMB=0.15 US\$.
² Base case forecast, Q1 2006.

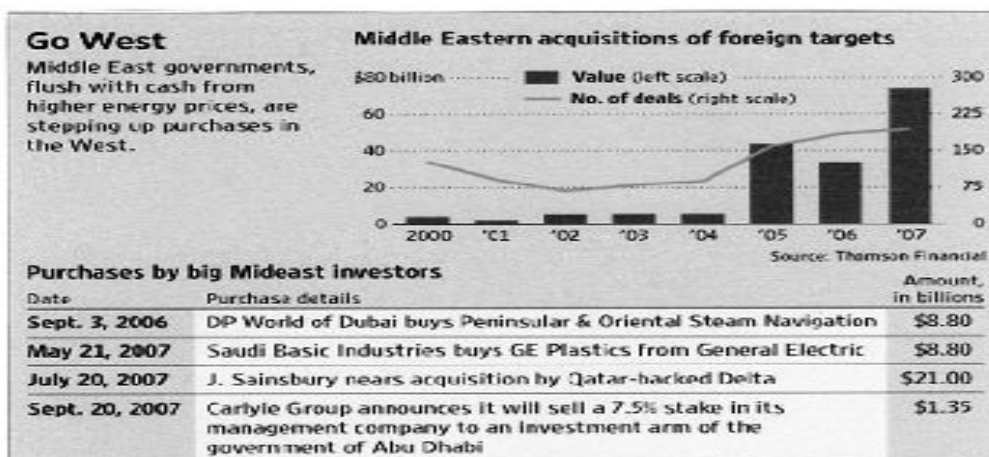
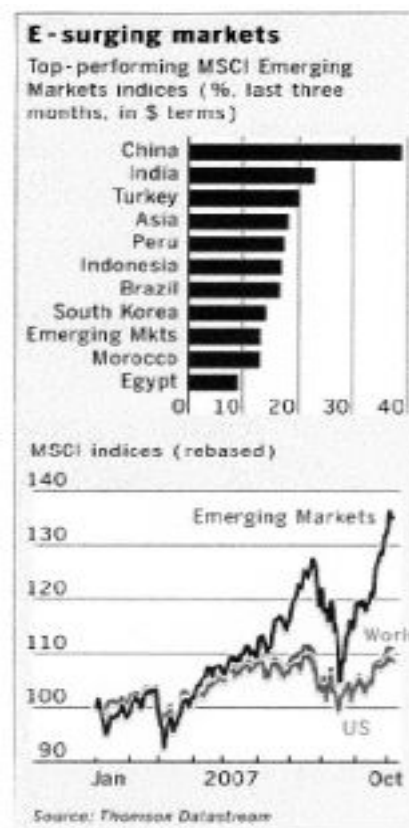
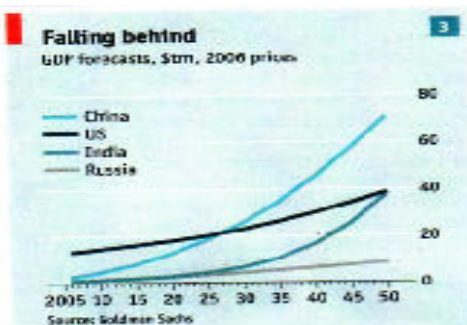
Source: National Bureau of Statistics of China; McKinsey Global Institute analysis.

Spending Spree

- RMB gradual appreciation, China's consumer market in USD = **90% of the US by 2014** @2x US annual growth (*The Rise of the Chinese Consumer – Theory and Evidence, Jonathan Garner, Credit Suisse First Boston, 2005*) China overtakes US as **largest contributor to world GDP growth** (*Economist, Sept, 2007*)
- **US\$800 b (2006)** <only US & Japan, but > rest of Asia combined. Fastest growing, 30% of global retail growth 2003-8, ~ US\$1.3 trillion in 5 years.
- By 2020, > ½ of China's 1.3 billion population urbanised. 4,000 km p.a. to existing 42,000 km motorways, to top the US by 2020. Car ownership only 7- 8 @1000 v world average 120 and US 600. China's **car sales** up 35% (2006) > 1m p.a. to exceed US over the next decade. Prices dropping 33% in recent years, likely to drop further by 10% by 2010.
- **Retail consumer goods sales** + 14.9% y.o.y (April, 2007) 2006 volume = 6.7 times 1990. 100 million One-Child generation. Urban residents 16.5% switch to new mobile phone every year. 26.1 % new MP3 every 2 years (*Horizon Research Group, 2007*)
- **Most popular:** housing decoration, healthcare, cosmetics, cars, high-tech goods, household appliances, culture and entertainment
- **Consumer credit** expanding rapidly e.g. car loans and credit cards

Gravity shifting to the East?

- Global freight east-centred : **Container port ranking**: Singapore, HK, Shanghai, Shenzhen, Pusan, Kaohsiung, Rotterdam, Hamburg, Dubai, Los Angeles
- **China** ascendant & **ME** becoming prominent
- **Emerging Market** surge



The Global Credit Crunch

- Global financial imbalance - **cheap money**. Mounting Asian FX reserves sterilized by investment in US Treasuries drive down bond yields and commercial interest rates worldwide. - **property prices** - private consumption (US1= 0.38 cents) + property speculation
- **Financial innovation**: Banks securitize/package mortgage loans and sell them off balance sheets as ‘*conduits*’ (estimated at US\$1.4 trillion worldwide). Private equities + hedge funds + financial institutions re-package and re-sell them as Asset Backed Commercial Papers (*ABCP*) or Structured Investment Vehicles (*SIV*) including Collateralized Debt Obligations (*CDO*)
- **Credit rating agencies** hired to advise on how to structured products for best rating.
- **Banks** = financial institutions? Many borrow short in ABCP market to lend long, more eager for faster turnover of conduits than quality of off-balance-sheet subprime loans e.g. 1/5 of all 2006 US mortgages = subprime, average 95% of property value; NINJA loans + 125% of property value to first-time home-buyers (cf Northern Rock)
- **Regulators and central bankers** (US and the EU) failed to curb such practice. Central banks focus on consumer price inflation > credit supply. When massive defaults happened, with sudden risk aversion, lenders all guarded their cash and credits dried up.
- Central banks had to save the day by massive cash injection (Fed \$US 41b on 1.11.07), guarantees, and lowering interest rates, at the cost of **moral hazard** and fuelling **inflation** (Greenspan/Fed ‘put’?)
- Fitch Rating initially estimated ABCP **exposure** at ~ 3% of assets globally. US\$368b LBO deals at risk. Goldman Sachs estimates US\$400 b losses (2.5% of US Equity) x 10% cap adequacy ratio = US\$ 2 – 4 trillion balance shrink (1T over next 2yrs) China’s exposure so far limited (BoC (US\$10.3 b), ICBC (US\$1.23b) and CCB(US\$US\$1.06b). Whole picture still to play out.
- **Profit warnings, write-offs and downgrades**: Merrill Lynch (-US\$ 8.4b); Citicorp (-60%, -US\$ 3.5b); UBS (AA+ to AA, -US\$ 3.4b), Deutsche Bank (-US\$ 3.1b); Morgan Stanley (-\$US 2.4b); Goldman Sachs (-US\$ 1.7b); B of A (- \$US 1.6b); JP Morgan Chase (-\$US 1.6b); Lehman Brothers (- \$US 0.7b); Bear Stearns (- \$US 0.7b); Moody June/July sweep 703 downgrades. 10-20% of > US\$ 1 trillion leveraged loans expected to default 2008-10. Risks of **contagion** to credit card and car loan markets, class litigation, world recession (Greenspan: 1/3 chance)? Proposed Market Liquidity Enhancement Conduit (M-LEC) – US\$ 100b for ‘SIV-positive’ - Citigroup \$US80b SIV?

The Age of Turbulence

(Alan Greenspan, *The Age of Turbulence – Adventures in a New World, June, 2007*)

- Declining **disinflation** (completing market capitalism) – China's rising export prices in 2007
- Lessening **propensity to save** in developing world
- Less **accumulation of US Treasuries** (10 Yr yield ~ >10% by 2030) weakening USD + raising interest rates
- Imperfect oversight over volume and complexity of **highly geared & integrated** global financial marketplace - counterparty surveillance
- Rising **risk premiums**
- Weakening US **budget discipline** – demise of 1990 Budget Enforcement Act and political allergy to interest rate hikes
- **China's** untamed growth of money supply, lack of financial flexibility, rising inequality and lack of democracy safety valve
- **India** high growth = 1% of employment, lingering licence raj (425 -1165 days to enforce contract), backward infrastructure, but ideas matter
- **Russia** – Dutch disease and selective rule by law
- **Latin America** – economic populism
- **EU** burden of welfare state and resistance to immigrant workers hopefully changing
- **US** current account deficit only 6.5% of GDP. Trade and financial imbalance = comparative advantage (specialization, declining home bias) – US saving to rise in face of aging provision (40% of Federal budget in 25 yrs)
- **Energy** shocks due to dwindling buffer, increasing concentration $\frac{3}{4}$ in ME, yet vast gas reserve in N America, hydrates in Arctic, nuclear, biofuels, renewables and alternatives (plug-in hybrids= 84% of US cars) Less $\frac{1}{3}$ as input to world economy over 3 decades (IP = $\frac{1}{3}$ of US market value)
- By **2030**, US GDP $\frac{3}{4}$ higher, core inflation > 2.2 % (2006), higher stock yields, and increasing conceptualization of GDP (but dysfunctional elementary and secondary education)

Questions for debate

- **GLOBAL FINANCIAL IMBALANCE** : China's *consumption* < economic development. *High Savings* for strong foundation in face of looming aged *population* in a few decades. The *US* to save more for pensions and Medicare?
- **RMB** already appreciating by about 5% p.a. *Undue haste* may harm foreign investment, low-margin exports, jobs, and overall competitiveness. May not save *US trade deficit* v other LDC substitutes or if all low-cost exporting countries appreciate currencies together. Labour-intensive products no longer viable in advanced countries. Western consumers need more affordable products against *inflation*?
- Low **INTEREST RATE** = *cheap money* but failed to sharpen *prudence*? *Inflation*? *Prolonged US deficits* and *weak US Dollar*? Diversification out of US Dollar as a *Reserve currency*? Global financial turbulence?
- How best should **RISK** be *priced* and *regulated* without sacrificing *innovation*? Basel 2 (not fully in place) to include off-balance sheet debt but still on capital adequacy ratios > liquidity?
- **GRAVITY SHIFT TO EAST** especially China, India and the Middle East? *Counterweight to risks of world recession* (China > US as contributor to global growth 2007)? *Asian Economic Community and an Asian Dollar*? *Energy crunch*? *Perceived threat from China, Russia and the Middle East*? Rising *protectionism*? *End of History* (Fukuyama) to *Clash of Civilizations* (Huntington)? *Western democracy* a panacea for development? *Washington Consensus* or *Beijing Consensus* e.g. China, Vietnam and Dubai? (Peerenboom, 2007) *China's strategy of Harmony* v internal and external challenges? *Eastern Alchemy for Global Harmony* - China's FX Reserve and the petrodollars to invest in responses to Climate Change? (www.andrewleunginternationalconsultants.com under Publications)

Thank you

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