A Storm Could Not Hurt the Sky

While the world has been focusing on the current turmoil of the Chinese stock market and the depreciation of RMB, let's not forget the big picture of the Chinese economy.

Economics is one of the most controversial subjects but one phenomenon which people generally agree on is the inevitability of economic fluctuation. Countries go through cycles of expansions and contractions which never end. We have seen countless examples of bubbles and recessions in history. In the past decades, we suffered from the oil crisis in 1970s, Black Monday in 1980s, the dot-com bubble in 2000s and the recent subprime mortgage crisis. But China, a country which enjoyed on average double digits growth throughout the period, appears to be immune to the downside of the economic cycle, or is it?

The Capital Flow

For so many years foreign investors played an important role in the Chinese economic fairy tale. Mushrooming new factories, millions of employment opportunities and the conveyance of technology and knowledge were examples of contributions made by the foreign investments. But apart from the direct contributions, these investments also brought along a vital underlying effect which served as the catalyst of the economic growth – a boost on the expansion of monetary supply. Unlike any other free-float exchange rate countries, the money flowed and invested into China had to be balanced by issuing equal amount of RMB by the People Bank of China ("PBOC") in order to hedge the appreciation of the RMB under the currency peg system. On normal days, a

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gradual increase of monetary supply fuelled the economy by providing credit and liquidity. But situation was different since 2009 when United State and other major economies in the world loosened their monetary base by conducting quantitative easing ("QE") and keeping the interest rates at zero. The excessive amount of cheap money created in the developed world overwhelmed the Chinese market looking for speculation opportunities and overstimulated the local monetary supply. (See Chart 1)

Not only the foreign investors but many Chinese companies also participated in the carry trade activities. The companies raised funds from bond and equity markets overseas and invested the money into businesses and, even more popular, the Chinese capital markets for assets included property, land, infrastructure, etc. Thanks to the fast expansion of monetary supply and the booming property market, the GDP in China from 2007 to 2014 kept growing at an idealistic pace of more than 9.49% on average compared to 5.75% in other emerging economies. (See Chart 2) A report by McKinsey Analysis measured the credit expansion during the same period also highlighted a similar sequel of the over expansion of monetary supply. It suggested that the economic growth was largely amassed on a combination of property mortgages, local government bonds, shadow banking loans, etc. which had quadrupled during the period.

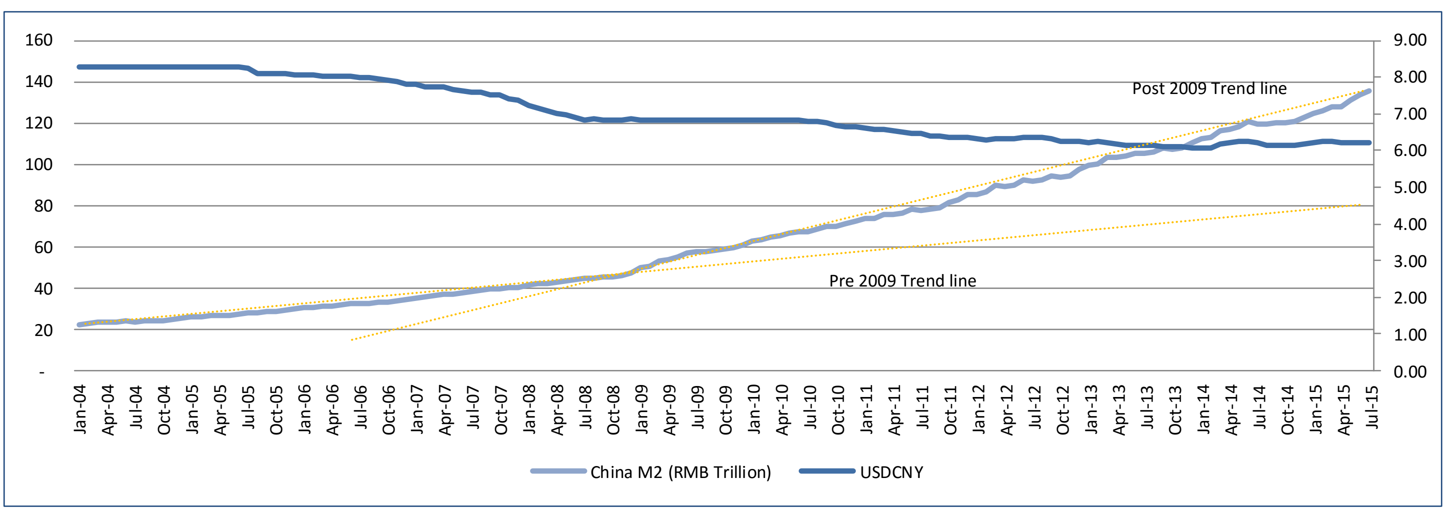
Eight years passed and the economic cycle turned around. Nowadays the U.S. has largely recovered from the financial crisis and the Federal Reserve started to restrain its monetary supply. QE was halted in late 2014 and the lift-off of interest rates is in sight. The capital inflow to China reserved along with contraction of asset valuations as market can no longer access cheap money and is expecting an increasing borrowing cost. The reverse trend did not happened suddenly as the economic slowdown had long been foreseen, but it was amplified recently by the chaotic intervention by the Chinese government in the stock market. The intervention exposed the inability for the government to tamp down the market volatility as well as its scepticism towards the free market.

The reserved capital flow not only affected the asset prices in China but also its currency. Under the fixed exchange rate system, the outflow of capital directly put pressure on the currency value and forced the central bank to support the currency peg by selling its foreign reserves. A situation which paralleled the 1997 Asian Financial Crisis when many Southeast Asia countries eventually ran out of reserves and were forced to devaluate their currencies brutally. Therefore when the PBOC joined its peers to devalue the RMB on 11 August, some investors suspected that it was a desperate measure to boost its weakening export and even speculated on a future decline in value of RMB.

China not alone

Despite the recent market downturn, do these speculations hold their ground? The Chinese economy is indeed slowing down but its GDP growth still stood at 7% in last quarter. Foreign capital is flowing out but China still has US$3.6 trillion in foreign reserves. In fact, we could hardly find any rationale for the Chinese government to support a further plunge in value of RMB. Boosting exports by devaluing RMB is hardly effective because the currencies of other emerging countries are relatively under-priced to the RMB against USD in recent years. (See Chart 3) Meanwhile the Chinese corporate debts are mainly denominated in USD and therefore a large depreciation of RMB might accidentally trigger another debt crisis among the already highly leveraged private sector. Moreover, the total export value is always determined upon the trade elasticity between price and quantity. Given the

Chart 1: RMB value and China M2 Supply



Source: Bloomberg AVISTA Research

uncertainty of the consequence of the depreciation, it is irrational for the Chinese government to risk its reputation on the export matter.

Instead, it is more likely that the recent fluctuation of RMB value only represented a bid for a more globalised financial leadership as a market set exchange rate is an important consideration for the introduction of RMB into the IMF Special Drawing Right ("SDR"). And if the RMB is going to be included in the SDR basket, it could on the contrary boost the RMB demand as a reserve currency and trigger a rebound of the RMB value in the long term. If there is any concern the investors may have on currency depreciation, China should not be the country in question but its more vulnerable peers.

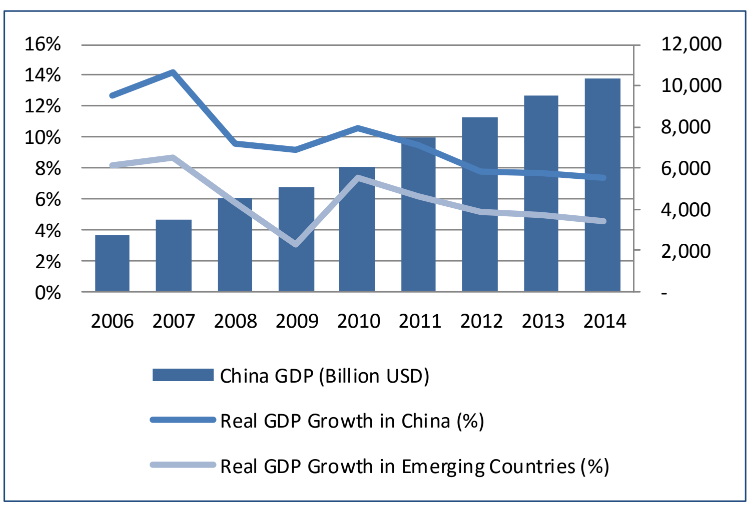
A Transformation in Sight

We believe that the significance of getting the SDR status for RMB is not only about its value but the process itself is a strategic step towards liberalising the currency. It serves the course of laying the foundation for the reform of the Chinese capital account. The existing economic model of China which relies on fixed asset investments, credit expansions, manufacturing and exporting, etc., is undeniably running down. The Chinese government knows exactly what their economy needs, from exporting to producing goods and services for consumers at home, from manufacturing low-tech replicates to providing high-end financial services and technology products. These transformations require much more sophisticated investors and policies to complement. The capital control is currently one of the biggest deficits in the Chinese economic system which is discouraging foreign enterprises from investing in China. Given that free capital flow is not achievable under a fixed currency system according to Mundell Trinity, the theory that a country could not at the same time enjoys free capital flow, fixed exchange rate and independent monetary policy, the recent RMB reform is actually a preparation step for easing the capital control. Some latest measures and policies, such as a general reduction of import tax, the introduction of Hong Kong Shanghai Stock Connect and the setting up of Asian Infrastructure Investment Bank, are also pointing in the same direction towards a free capital account.

If China wants to sustain its growth and continue being one of the dominate economic powers in the world, it should no longer count on monetary policy and fiscal stimulation but instead fundamental reforms on its economic system. China still has plenty more room to cut its interest rates and has a war chest of US$3.6 trillion in foreign reserves but none of these alone could guarantee a sustainable growth on an overproduction and credit inflated economy.

Facing an approaching interest rates hike and the reverse of capital flow, it is high time for China to unleash its potential by relaxing the capital control and carrying out more fundamental reforms. It should no longer compete with other emerging counties on attracting hot money and low -tech manufacturing business. Instead it should build up its standalone economic power with sustainable domestic demand and an all-rounded market-driven economy supported by a diversified, fair and open environment for businesses. Going through the transformations is tough but the Chinese government should not flinch from the short term turbulences or lose the big picture, as the title suggested 'a storm could never hurt the sky'.

Chart 2: GDP of China and other emerging countries



Source: IMF World Economic Outlook, AVISTA Research

Chart 3: Major Asian currencies against USD

Country	Currency	Performance Since 2014	Performance Since 2015
China	CNY	-4.6%	-2.0%
Japan	JPY	-19.3%	-3.8%
Korea	KOW	-11.7%	-7.8%
Malaysia	MYR	-21.1%	-12.8%
Indonesia	IDR	-12.8%	-9.6%
Australian	AUD	-22.3%	-10.6%

Source: Bloomberg, AVISTA Research