# Letter from the President

## Will China Continue to Shake the World?

### Perspectives from the Asian Financial Forum: Hong Kong, January 16-21, 2012

Napoleon must be nodding sagely in his grave. The Little Emperor once said: "Let China sleep, for when she wakes, she will shake the world." China has awakened – most decisively – and a seismic shift in economic and financial power is underway.

We must either take advantage of these developing economic trends, or risk the consequences of ignoring them. This was clear in the discussions and presentations of the Asian Financial Forum (AFF) in Hong Kong (January 16-21), and a follow-up trip to Guangzhou.

The AFF brings together influential leaders to interpret and discuss trends and developments in Asian financial markets. I was invited by the Hong Kong Government and the Hong Kong Trade Development Council to lead the Canadian delegates this year, giving me an opportunity to hear presentations from the HK Monetary Authority and Deloitte and E&Y, and meet with government and business leaders, including executives with the Asian Financial Markets Association to discussion regulatory reform. The HK Trade Development Council also arranged an eye-opening day-trip to Guanghzou in southern China for the Canadian delegates to the Forum.

**China's Immediate Future: Four Key Questions**

Prior to embarking on the trip, I had four questions on my mind:

- What will be the likely course of liberalizing the renmimbi exchange rates and markets?
- Will China experience a hard landing or engineer a soft landing in response to slowing global growth?
- Will China continue to make progress transitioning from export-driven growth to reliance on domestic demand?
- And finally, what will be the likely magnitude and format of capital inflows and outflows? For example, will China continue to tap overseas markets to finance infrastructure spending in the country? Will China accelerate foreign direct and portfolio investment spending, particularly for reliable access to commodities markets?

Definitive answers to these questions are hard to come by, but I did gain many insights, some useful to assess China's prospects for growth and the economic impact on Canada.

**Liberalizing the Renmimbi Market**

In discussions about China's recalcitrant move towards convertibility of its currency, what is often not realized is that trade-related capital flows are already freely convertible from the renmimbi to other major traded currencies. Only 10% of China's trade is in renmimbi, with the rest primarily denominated in U.S. dollars and the Euro – but renmimbi trade flow is still significant given annual volume of China's trade totaling 1.7 trillion RMB a year. The Hong Kong market dominates trade settlement in renmimbi, totaling 83% of all transactions.

Esmond Lee, Executive Director at the Hong Kong Monetary Authority, described the trade-related offshore renmimbi market as analogous to the Euro-dollar market -- with one major exception. Chinese authorities restrict the flows of renmimbi back into the domestic market, while U.S. authorities impose no controls on the flow of U.S. dollars back into the U.S. market. This restriction complicates the liquidity of the offshore renmimbi market; however, the HK clearing banks have access to CNAPS (China National Advanced Payment System), along with the Mainland banks, and can facilitate renmimbi settlement for the global interbank market through the Chinese interbank market. Inefficiencies remain, however, as these HK settlements must receive prior approval from People's Bank of China.

A senior Chinese government official, Li Wei, President Development Research Centre, in an address to the Forum delegates, noted there were some 900 Mainland offshore corporate affiliates, roughly 160 subsidiaries listed on the HKEx – the "Red Chips" – with the remainder registered in jurisdictions around the world, mostly in the British Virgin Islands and elsewhere in the Caribbean, conducting business globally. These trade-related transactions are readily convertible into and out of renmimbi.

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Under pressure from the OECD, Hong Kong has strengthened transparency of tax information of HK affiliate firms, partly to improve its standing as a recognized global market and to establish double tax agreements (tax treaties) with European, Asian and South American countries. Under these agreements, dividends flowing to these affiliates would not be subject of foreign withholding. There are now agreements signed with 21 countries, with Canada in the midst of tax treaty negotiations with Hong Kong. It is anticipated that, as a result of these tax treaties, overseas Chinese affiliates will move back into Hong Kong to benefit from the arrangements. One interesting corollary is that once a tax agreement is reached with Canada, Hong Kong-based affiliates may establish Canadian affiliate operations to pursue business directly in the United States, to benefit from tax efficiency opportunities while lowering their profile in the U.S. For example, the Cheung Kong Group (Li Ka-Shing) could expand energy, communication, logistics businesses etc. in the U.S. via a Canadian subsidiary.

While the renmimbi is fully convertible for trade-related transactions, there are restrictions on the conversion of investment flows. Several years ago the Chinese established quotas for direct and portfolio investment flows moving both in and out of the country. Mainland institutions designated as Qualified Domestic Institutional Investor (QDII) can purchase overseas investments subject to quota, and foreign financial institutions designated as Qualified Foreign Institutional Investor (QFII) can similarly purchase renmimbi investments. As a result of increased trade and investment flows, much of it moving through Hong Kong, renmimbi-denominated deposits with Hong Kong-based banks total 600 billion.

**Chinese RMB per USD**

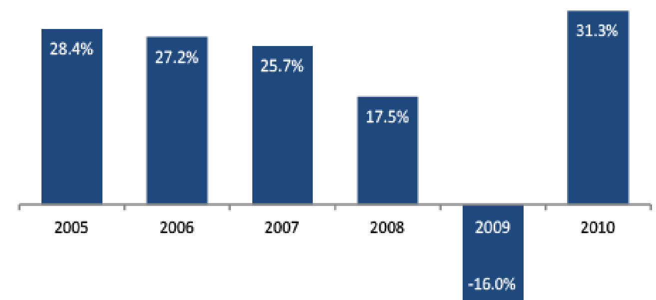
What is evident from all this is that the Chinese authorities are moving steadily to open up the renmimbi market, carefully monitoring the impact of their actions on currency markets and trade flows. The first consideration is to avoid sharp appreciation in the currency to preserve trade competitiveness. So far the informal renmimbi exchange rate tracks closely to the official rate. Second, capital outflows reflecting unrestricted convertibility could accelerate and erode control over domestic financial markets, as domestic borrowers and lenders could source capital and investment offshore, making it difficult to ration credit and ensure preferred lending to state enterprises. We are a long way from that, partly explaining why the consensus is that full convertibility is at least 5 to 10 years away.

Despite caution in opening the renmimbi market, China has taken steps to designate Hong Kong as the offshore trading centre for renmimbi-denominated stocks, bonds and derivatives. The government has launched a successful renmimbi bond market in Hong Kong, and in time has announced it will permit renmimbi listings of large and mid-sized Chinese companies on the HKEx, the creation of listed ETFs and derivatives.

### Hard Landing or Soft?
### The Answer Depends on Domestic Demand

There has been much speculation about the impact of the global slowdown on the Mainland economy. Exports declined from a 40% share of the economy to 30% in the post-2008 crash. As export volumes declined in the wake of the financial crisis, China embarked on a program of massive infrastructure spending on roads, airports, buildings, etc., to bolster economic growth. Not only has this spending been on an unprecedented scale and broadly based, but has been initiated quickly. Major projects can be "shovel ready" quickly.

**China's Export Growth**




Source: PRC National Bureau of Statistics

As a case in point, the transformation of Guangzhou in the last two to three years has been nothing short of remarkable: 100-story office towers, commercial buildings, rail systems, museums, housing developments have sprung from nowhere in two years. The speed of urban transformation is extraordinary. Much of this growth has been driven by state-owned enterprises. We visited Yu Xie Group, an archetypal corporate structure in China with major holdings in real estate, energy, and finance in Guangdong province.

Consumer spending has been building steadily in recent years, related to burgeoning economic growth and an emerging middle class. The government has spurred this spending by requiring state-owned enterprises to increase employee wage rates by 10-20%. The lack of a social safety net for health care and retirement will continue to act as a drag on consumption, but consumer spending will likely forge ahead barring a black swan event such as a collapse in the property market.

**Wine Prices Down – Will Property Prices Follow?**

State and local governments, and multinational companies operating in China, have turned to the rapidly developing renmimbi-denominated bond market, the "Dim Sum" market, to finance long-term projects in the Mainland. Eighty-seven renmimbi bond issues were launched in Hong Kong in 2011, totaling US$17 billion. For example, in November Caterpillar issued a RMB 1 billion issue and McDonald's raised RMB 200 million last August. This money has been channeled into infrastructure expansion on the Mainland.

Infrastructure spending has obviously supported growth in recent years – the annual figure for economic growth in 2011 just reported at 8.9%. The other growth phenomenon has been property investment in China, for residential and commercial projects. Some speculate a collapse in the property bubble could precipitate a sharp slowing in growth rates in China, with negative consequences for commodities markets, and by extension the Canadian economy. Last year property investment grew at 31%. If growth stalls, leaving investment at the same frenetic pace as last year, that would knock 2.5 percentage points off the national growth rate. Is it likely? How far will prices contract? Are the banks properly cushioned? What will happen to consumer spending? Tom Holland, respected columnist at the South China Morning Post, noted the tight correlation between fine wine prices and property prices – wine prices being a good proxy for the excess liquidity sloshing around in the financial system. The three auctions of fine wines this year in Hong Kong have been calamitous.

**Conclusion: High Growth Still Ahead – But Deep Reforms Needed**

Growth in the Mainland economy may indeed slow this year for several reasons, not the least a possible sharp downturn in the property market. But none of this changes the fact that China has become an economic power, displacing Japan and closing in on the United States. The economy is likely to make the transition to greater balance, faster than expected as the middle class expands and per capita incomes increase. The Asian economies, notably China, have now become the engine for global growth. Nobel Prize winning economist Joseph Stiglitz emphasized this observation in his keynote remarks at the conference.

It is ironic that, as Asian growth accelerated in 2006-2008, and offered attractive investment opportunities, capital flowed to the developed countries. This largely reflected inherent inefficiencies in capital markets, including a managed Chinese currency that caused capital to fund the U.S. deficit and low tax rates -- and poor risk management, with complicit rating agencies, that understated inherent risks that channeled capital into derivative products and the U.S. housing market.

All this must be put in perspective, however. Despite its economic success, the country is in need of "deep reform", a point emphasized by Tomson Li, CEO of one of China's biggest private companies, TCL Corporation. State capitalism can make decisions quickly, but often those fast decisions allocate resources inefficiently.

The economic growth differential and relative investment returns between Asia and the developed world have become even starker as growth prospects in the U.S. and Europe have collapsed. Canada, and Canadian investment firms, needs to shift their focus east. Two hundred years on, Napoleon's words are more relevant than ever.

Yours sincerely,

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January 2012