Economics

Issue 33 – Don't get your Chinese order wrong

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1. Why concerns over China's over-build are over-blown
We are being told in ever shrill tones that China's economic growth is poised to stall, indeed some claim it has already done so, a shock we are warned will plague us all. Those fearful of a global contamination from a "China Syndrome" point to its many 'ghost' towns as testament to its 'impressive' growth of recent years being little more than an unsustainable fiction. Nay saying of China's growth has been given renewed urgency by the travails of the Shanghai stock index and the rear-guard efforts to support it, described by many as desperate, and ultimately not simply destined to fail but to make matters worse. Those negative on China also point to "shadow banking" problems and to its one-child policy as a demographic time-bomb. If the decline in China's equity market were not enough to panic China bulls and excite China bears they have both been confronted by falling commodity prices as further 'dirty' proof of "Broken China". The argument after all is that those who pointed to sharply higher resource prices as evidence of China's impressive growth must now recognise their cheapening as a clear indication all is not well across China's economy. In what follows I wish to put forward my contrarian view of China's economic outlook.

2. How China has learnt from Japan by doing the opposite
Thirty years ago China was struggling to reconcile Deng Xiaoping's ambition of socialism with Chinese characteristics with Mao's original vision of a closed centrally controlled economy. Back in the mid eighties when China was economically inconsequential on the global stage there was seemingly one Asian growth Star, Japan. In this section I'd like to explain how Tokyo has spent three decades writing the definitive "How not to run an economy" manual, otherwise titled "Lessons in economic hara-kiri". This book is clearly a best seller in Beijing, where it is being used to avoid China following Japan's ruinous path.

3. The world's currency landscape: a singular lack of plurality, but not for much longer
The way the world presently saves its wealth and the way it prices much of its resources shows a singular lack of plurality. And whilst it has lasted for some time this singularity cannot continue indefinitely. I would argue in fact that we are on the cusp of change, one which we would welcome. The catalysts for this change will be a pincer movement. From one direction the IMF in Washington will anoint the RMB into its Special Drawing Rights currency basket. From the other direction the PBOC in Beijing will take action to encourage ever larger flows of Foreign Portfolio Investment into China.

4. Issue 32 – False Chinese Whispers (May 2015)
There is a famous apocryphal story relating to events in the trenches of WW1. Ahead of a crucial infantry charge from our lines, a message was relayed by word of mouth and from trench to trench. Legend has it that what began as "Bring reinforcements, we are going to advance" ended as "Bring three and four pence, we are going to a dance". From such a misunderstanding, disaster is certain to follow. And what I hear today from those claiming to be "fully informed" towards China's economy, seem no less tangled in misinterpretation.

5. Issue 25 – Beijing has its fx right (April 2014)
China's currency is whatever Beijing chooses it to be. And over recent weeks it has been sliding. To those curious as to what Beijing is playing at with the RMB my answer is this is no game and, if it was, Beijing can be the only winner.

6. Issue 20 – Hong Kong Matters (June 2013)
Just how much longer can Hong Kong continue to have its dollar united with that of the US when China's currency edges ever higher?

1. Why concerns over China's over-build are over-blown

We are being told in ever shrill tones that China's economic growth is poised to stall, indeed some claim it has already done so, a shock we are warned will plague us all. Those fearful of a global contamination from a “China Syndrome” point to its many 'ghost' towns as testament to its 'impressive' growth of recent years being little more than an unsustainable fiction. Nay saying of China's growth has been given renewed urgency by the travails of the Shanghai stock index and the rear-guard efforts to support it, described by many as desperate, and ultimately not simply destined to fail but to make matters worse. Those negative on China also point to “shadow banking” problems and to its one-child policy as a demographic time-bomb. If the decline in China's equity market were not enough to panic China bulls and excite China bears they have both been confronted by falling commodity prices as further 'dirty' proof of “Broken China”. The argument after all is that those who pointed to sharply higher resource prices as evidence of China's impressive growth must now recognise their cheapening as a clear indication all is not well across China's economy. In what follows I wish to put forward my contrarian view of China’s economic outlook.

There is one over-arching question I would ask those challenging Beijing's ability to manage China's economy through this admittedly challenging period of re-orientation. What evidence do they have of Beijing’s economic ineptitude thus far? Has this group forgotten how when Beijing was tested in 2008 by the 'North Atlantic financial crisis' it came through remarkably well? True, every possible fiscal and monetary effort was made in Washington and London and after some delay across Europe to forestall what threatened to be an even more nasty shock (intervening in equity and debt markets and even using the nationalisation of banks and putting pressure on courts to interfere with foreclosures). No less true is the fact that Beijing had to react in turn to these reactions. I for one believe Beijing did so with credit, quite literally in fact.

One could argue that the global economic re-balancing which is needed could have been triggered from 2008 had not dramatic fiscal, conventional and non-conventional monetary action been taken on either side of the North Atlantic and then Tokyo. For the most part these actions covered up rather than cured the fundamental supply-side, budgetary and debt problems besetting large swathes of the mature world. Pushed back it may have been but this re-balancing remains essential and is certain to happen. It will be a re-balancing of China's growth and closely linked to this a re-balancing of global savings. It will force some nations to restructure back towards mercantilism whilst others follow China along a path of internally led growth. It will lead in short to a reappraisal of how we see the world in economic terms. And those who look dismissively away from China will miss the best bit of the story.

Whenever I am earnestly warned that China has 'over-built' property which will never be of economic value I ask my informer to cast an eye out across Canary Wharf. And whenever I am asked to defend my positive China view in the face of Beijing's market manipulation I reply that we should reflect on how we in the 'advanced' economies have intervened in capital markets; from banning the short-selling of equities to Quantitative Easing in debt markets. Furthermore, when I am confronted with concerns over China’s demographic outlook I reply that I am a great deal more concerned with birth rates in Japan, India and across a great deal of Europe.

Let me begin my defence of China by making a direct comparison of its ghost town 'follies' with what is now a flourishing Docklands.

Whilst it is perfectly true Olympia & York's foray into the east of London ended in failure, - entering bankruptcy in 1992 - I would argue two factors contributed to this, one of which is not a problem facing the People's Bank of China and the other easily remedied by Beijing's authorities with responsibility to fiscally manage China's economy. First, the UK was not in command of its monetary management for a number of years, only freed from its German shackles by the pound’s shock exit from the ERM on that fateful White Wednesday, September 16th 1992. This of course came too late to save O&Y's investment or that of the banks whose capital helped fund it (to which I will return in a moment). Canary Wharf’s initial occupational woes were made worse because the development went ahead in the wrong commercial sequence; transport links came last; the Jubilee extension first proposed many years earlier only actually opened in 1999. For all the initial travails I would argue that O&Y's vision has not simply been realised but surpassed. Looking at the Docklands today we can see space which was empty is now much sought after. Indeed, development activity continues. One could make a similar argument for Edinburgh Park, which having opened in 1995 had to wait eight years for a proper rail link to realise its occupational and wider economic potential.

To me there are powerful parallels between what were once ghost towns in Canary Wharf and Edinburgh Park and those developments seemingly languishing in emptiness across China. The plain fact is that just as we had to do with Canary Wharf and Edinburgh Park so China needs to significantly improve the transport infrastructure to its 'ghost towns' so as to bring them to economic life. And I have every confidence Beijing will fund this construction by using its vast foreign currency reserves (see chart 7). In fact this development activity will provide a great deal of work. True, in the meantime investors across China who borrowed heavily are suffering financial pain. However whilst the UK could not cut interest rates until the pound unceremoniously exited the ERM, China has no such shackles, Beijing has been and can continue to ease the lending environment. Indeed, much like the UK experience in the early 1990's those buying property assets from distressed sellers will get their hands on real estate whose intrinsic value is far greater than their market value. We might indeed see buyers get hold again of their original developments; just as Reichmann did in 1995 with Canary Wharf.

Let me turn now to the reversal in the Shanghai equity market and the intervention from Beijing. There are those arguing that when the intervention ends the slide in China's equity market will not only resume but become even more disorderly. This may well prove the case if in the meantime there is no change in China's economic management. To me the idea Beijing will do nothing is absurd. *Ceteris paribus* is an absurd assumption because there is plenty Beijing can do. As I have already pointed out the PBOC has unilateral control over monetary policy whilst moreover China has a reserve of foreign savings - carefully accumulated over more than a decade of comparative thrift – to spend as it wishes. In fact Beijing has at its disposal a raft of policy actions which should dispose of concerns that somehow China's economy will stall. It even has to hand high scoring "diplomatic cards" to play which could win it regional economic dividends, for example orchestrating a regime-change in North Korea.

After its rally following "intervention" the Shanghai stock market has resumed the downward momentum. Should we really read this as a concern? As strange as it will sound to claim as much I would say we should not assume financial market metrics are accurate barometers of real economic conditions. For their part policy maker must never allow financial markets indices to lead their strategy; financial markets should follow instead. We have lessons enough of where financial market tails have waged the real economic dog. One of the most famous instances of this came almost thirty years ago and became coined in financial folklore, as Black Monday.

From Monday October 19th 1987 stock markets around the world tumbled. A range of measures then followed to try to introduce circuit-breakers to stop program trading exaggerating downwards price movements in otherwise thin volumes. As well as these technical changes, there was a rush to cut interest rates in the wake of Black Monday. The result was to take a financial market 'correction' and transmit it into real economies, these knee-jerk monetary moves contributed in large part to the "real" recessions which hit from 1989. The lesson for Beijing is that it should not exaggerate how financial market events feed into real economies. It should in short be careful in picking its response to stock market volatility. Despite concerns that it is "over-reacting" I have no doubt Beijing is doing no more and no less than needed. Indeed, those concerned by the extent to which the Shanghai Index fell before Beijing intervened might like to reflect on how far it had risen in the run up (chart 1) or its fall in 2008 and how China's GDP continued to expand thereafter. They might also like to reflect on how the Nikkei "took off" once the shackles on the yen were themselves taken-off from September 1985 (chart 2). Quite frankly if you believe as I do that the RMB is "under-valued", you must believe tautologically that the Shanghai index and all other RMB financial metrics are fundamentally undervalued.

Chart 1: China GDP vs. Shanghai Index

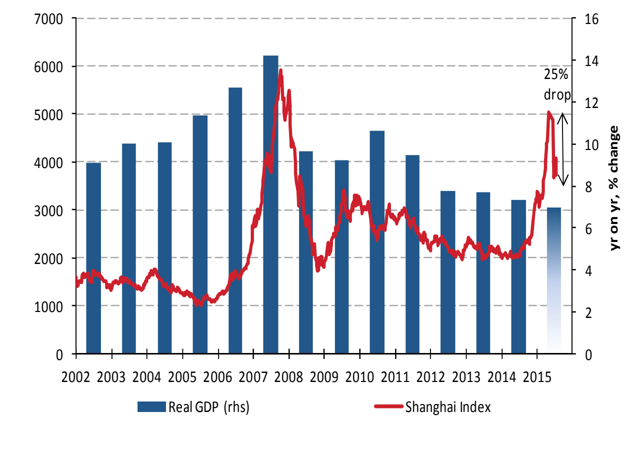
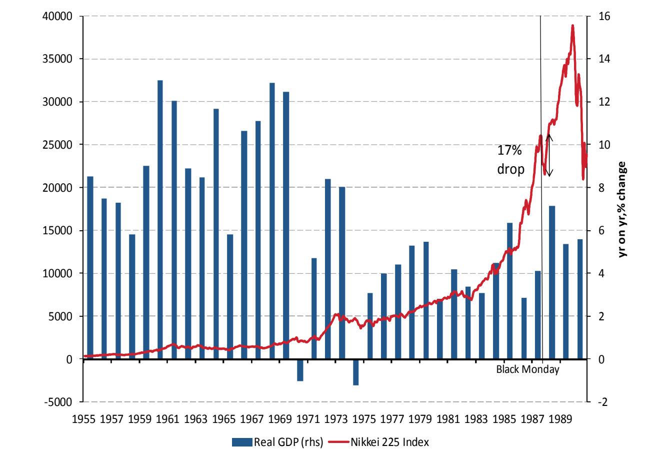


Chart 2: Japan GDP vs. Nikkei 225



Source: Bloomberg, World Bank, Toscafund

Am I dangerously and potentially ruinously sanguine? Well, assume I am wrong and that there is a considerable quantum of real estate across China which will never be economically viable; wrong type of space and/or in the wrong place. Well, in the process of these perceived follies being constructed a great many Chinese were put to work, mostly with limited manual skills having only recently arrived from rural areas. For these the opportunity cost in being employed building “follies” was extremely modest. And if there is any demolition needed workers will be employed to bring down what was lifted up. We must in short accept that what has made China's economy the impressive growth machine it has been over the past decade is that Beijing has taken every opportunity to make sure it continues to make things; even if it meant making and selling us in the over-consumed developed world things we in reality never really needed replaced. It has also sometimes meant building properties it too may not ultimately ever have a true economic need for. And on the theme of follies, let me repeat once more that there was a time when some saw Canary Wharf as a White Elephant and indeed the Millennium Dome as one too. Looking across the flourishing Docklands, none can now think there is anything folly about it. Indeed if one wishes to reflect on what a real (un)commercial folly is one could point to the considerable investment made in what in their time seemed insurmountable technologies, only to find themselves quickly surmounted by the next development. Take the extensive and expensive laying of cables through the 1990's most of which are now dark or unlit. And the reason for this is no conspiracy to waste or commercial lunacy, but as I said the speed of obsolescence brought about by rapidly advancing technology.

I will turn now to the seemingly unrelenting fall in commodity prices.

If the decline in China's equity market were not enough to panic China bulls and excite China bears they have both been confronted by falling commodity prices as further 'dirty' proof of “Broken China”. The argument after all is that those who pointed to sharply higher resource prices as evidence of China's impressive growth must now recognise their cheapening as a clear indication all is not well across China's economy. Well, I do not agree.

The price of most things reflects the conjunction of demand with supply. It is quite possible then that pricing could weaken if the supply curve moved to the right even as the demand curve also continued moving to the right. Weakness in pricing would be all the steeper the greater the right-wards move on the supply-side relative to the shift in demand.

Why do I see an increase in supply as a far greater contributor to falling resource prices than a downward demand-side explanation? Well the answer can be found in the considerable investment made searching out and developing new sources of commodity supply across large swathes of the world when their pricing was high and efforts to find them lucrative. After all there was no shortage of financial capital to commit to these adventures given the bulbous balance sheets of the major mining companies. There was also a voracious appetite amongst investors to fund the exploits of smaller exploratory miners. Over recent years the evidence for this was the improving fortunes of those companies in the US, UK, Sweden, Germany, Japan etc. involved in the manufacture of equipment for the exploration, extraction and transportation of hard and soft commodities. As the saying goes, during a gold rush the only ones guaranteed of profit are makers of shovel, pans and dungarees. Efforts to capitalise on high resource prices were also welcomed economically in the countries where investment was being sunk - quite literally - in mining projects. As financial capital and capital goods flooded in to them so jobs were created in Australia, Bolivia and Canada, as well as Mozambique, South Sudan and Zambia. Indeed, there seemed no corner of the world where some exploration was not taking part.

Well, it was only a matter of time before all this frenetic investment would result in a material (sic) move higher in the supply of commodities. Indeed in the case of oil there was even a shift to other sources of energy, for instance corn ethanol, oil sands and shale gas. Now as far as China is concerned steep declines in commodity prices are in effect sharp falls in its ingredient costs.

Far then from 2015 proving a poor year for China's visible trade surplus, it is proving the best year yet. Turning to economies which have seen sharp falls in the dollar price of the commodities they extract and export the point I would make is that the vast majority have seen steep declines in their currencies. As well as improving general competitiveness the latter has largely mitigated the former in terms of local currency revenues from exporting commodities. Am I seeing implausible silver linings in dark clouds? No, I am just trying to add some economic sense to all the sensational nonsense surrounding China and commodity prices.

Let me close by bringing together the elements covered in earlier paragraphs. It would be naive to claim all the new industrial, office and residential real estate we have seen developed across China has an economically valuable future. This accepted I consider it no less naive to ignore the lessons from our own past; just think of the present price tag on 1 Canada Square against what it cost Paul Reichmann to build in 1988, and what price he paid to buy it back in 1995. In fact here's an idea, next time you are told the Chinese economy has been grossly over-built and much of its commercial property is worthless, please ask the person making the claim whether they would have preferred to buy 1 Canada Square at its sale prices in 1992 or that of today?

2. How China has learnt from Japan by doing the opposite

Thirty years ago China was struggling to reconcile Deng Xiaoping's ambition of socialism with Chinese characteristics - launched from December 1978 - with Mao Zedong's original vision of a closed centrally controlled economy. Back in the mid eighties when China was economically inconsequential on the global stage there was seemingly one Asian growth Star, Japan. In this section I'd like to explain how Tokyo has spent three decades writing the definitive "How not to run an economy" manual, otherwise titled "Lessons in economic hara-kiri". This book is clearly a best seller in Beijing, where it is being used to avoid China following the same ruinous path Japan has.

For close to twenty years from the mid 1950's Japan's economy enjoyed a rate of real GDP growth of c10%. Although its pace of expansion was interrupted by the shock of "OPEC I", Japan's economic growth quickly resumed for another dozen or so years at a still impressive c4.5% (chart 2).

Although Japan's economy had been strengthening for decades from the 1950's neither its currency nor equity benchmark - the Nikkei 225 – had. This failure was seemingly strange since an economy's currency and equity market are often seen as a barometer of its real economic strength (chart 3). The reason was simple; Tokyo engaged in manipulating markets to hold the yen down, and this naturally held down the value of all financial measures priced in the yen, including equity prices. This would all change following a gathering of the world's main finance ministers in September 1985 at the Plaza Hotel in New York.

Following the Plaza Accord the yen embarked on a stellar rise, doubling in value against the dollar over the next two years. One consequence of this was to make Japanese financial and commercial institutions proportionally that much weathier in terms of their global purchasing power. This should have been the beginning of a new chapter of long-term growth for Japan. Instead, it provided a handful of years of booming asset markets which were followed by Japan being stuck in an economic quagmire for much of the period since 1991.

Chart 3: US Dollar per Yen

Chart 4: Nikkei 225

Source: Bloomberg, Toscafund Note: red line signifies the Plaza Accord on September 22, 1985

There are those who see the Japanese boom-bust experience as a precedent for how China will perform. I could not disagree more. Rather than Japan providing an example of where China is heading I would argue the very opposite. In fact as I have already mentioned Tokyo has very helpfully provided Beijing with a play-book of "how NOT to manage an economy".

Japan's experiences have provided China with plentiful reasons not to allow Washington to determine when and by how much its currency appreciates. This is not to claim the yuan hasn't been or will not continue to strengthen against the dollar, but rather to say the pace of its appreciation will happen on Beijing's chosen trajectory (see chart 6). Another interesting lesson learnt by China from Japan is how not to spend your wealth. Whereas Japan chose to spend its riches acquiring trophy or shiny assets – for example real estate across London and Manhattan - Beijing has been accumulating dirty assets across South America, Africa and wherever else it can find mines, oil fields and arable land to buy or lease. The contrast in behaviour over foreign investment extends further. In a considerable spurt of Foreign Direct Investment Japan opened transplant factories extensively across Asia and indeed Europe. Rather than this off-shore capacity coinciding with rationalisation of its on-shore manufacturing base, these actually compete with one another. China is making no such mistake. True it is involved in Foreign Direct Investment. It is doing so however largely buying IP which it can not only exploit at source but "copy" back in China. The UK has experienced this with the acquisition of Rover Group and Manganese Bronze, in both cases China cheaply buying engineering platforms which it would otherwise have had to develop from scratch.

Remarkably and extremely curiously for a nation sitting on tectonic fault lines, Japan seemed obsessed with building considerable nuclear capacity, which as we sadly know has recently cost it dearly in human and financial terms. Now, whilst Beijing has hardly held back on building nuclear capacity to power its economic growth with, this has come alongside considerable investment in conventional power generation facilities.

Japan's "how not to behave" playbook does not end here. As the yen strengthened Tokyo failed to encourage its use as a cornerstone global currency. By contrast Beijing has relentlessly engaged in creating bilateral agreements, in effect disintermediating the dollar from trade between it and an ever increasing number of its economic partners around the world (see section 3 chart 8). Linked to its failure to make the yen a significant global reserve currency Tokyo also missed the chance to internationalise its sovereign debt, a failure which deprived it of what could have amounted to considerable capital inflows. Beijing will not make the same mistake. Nor too is China making the mistake of discouraging Foreign Direction Investment (FDI) the way Japan has and continues to do.

The Japanese equity market roller-coaster experience also provides Beijing with a lesson it can learn from. Against the backdrop of recent falls in the Shanghai Index Beijing will be aware that in the wake of Plaza Accord the Nikkei Index rose strongly in response (chart 4). China's authorities will know that a strengthening currency will of itself attract Foreign Portfolio Investment into its equity market, a realisation that will allow it to see recent declines into the context that the Shanghai Index is under not over-valued.

Japan's "how not to behave" playbook even contains a chapter for China to profit from by doing "the reverse" on food policy and another on demographic strategy.

Whilst Japan continues to resist joining the "GM crop r/evolution" China shows no such reticence. Knowing full well that reducing the real cost of food – in particular the pace of food price inflation relative to the rate of wage growth - is as important to freeing up discretionary household spending as cutting the real cost of energy. And whereas Japan has steadfastly kept up barriers against the import of foodstuffs, China has been more than accommodating, lifting the fortunes of its neighbours in the process, notably New Zealand. Furthermore, despite being in desperate need of domestic economic growth, Japan has engaged in a 'closed society' unwelcoming of immigrants, doing so whilst the birth rate of its indigenous population has long been and continues to be below the replacement threshold. Whilst some see China being hostage to "the one child policy", the reality is that this has effectively been abandoned; China now boasting one of the world's highest per capita rates of multiple births. For those familiar with its cities China is home to a growing number of ex-pat professionals whilst also attracting migrants from across the region; not least North Korea, which leads me to another differentiator with Japan. Whilst Japan has held aloof from its neighbours China has been hegemonic. Rather than see this as a negative I would argue that Beijing has the power now to turn it into a positive, using its considerable influence in Pyongyang to considerable diplomatic and economic purpose.

I have pointed out that during its *halcyon* post-war wealth years Japan acquired trophy assets in the UK and US and also investing in "transplant" factories widely around the world. It however failed to 'take' ownership of resource' assets. To in part explain Japan's failure to use its post-war wealth in the most 'resourceful' way, particularly around Asia, one has to understand its past behaviour.

Few historians will doubt that an important element of Japan's military imperialism in the 1930's was economic ambition. In over-running Manchuria, Borneo, Malaya et al, Tokyo's military expansion followed a map identifying the whereabouts of the resources it needed to feed its industrial ambitions.

It is quite credible then to argue that Japan's failure in the post-war years to 'gain ownership' of overseas resources was a combination of a reticence within Japan to expand and a reluctance around the world to allow it, each the legacy of its efforts to take these assets 'over' in the 1930's. This said and as much as some see no distinction between a forceful with a financial 'take-over', I do. And whatever the post-war feelings in or outside Japan about 'taking over' foreign resources I see no reason why China should be reluctant to do so, nor why sovereign nations should be reticent in selling to it the rights to their natural resources.

One could argue that had Japan used monetary not military force in the 1930's to 'acquire' resources the world would be a markedly different place today. So why didn't it simply buy what it needed? Well, at the time Japan arguably had no other option than use might over money. After all, the Asian context of the 1930's was a colonial world. In reality it wasn't simply a case of Tokyo wishing to 'buy' Asia's resource assets, these had to be 'sold' by those colonial powers which had de facto possession of them. And Great Britain for one was never in the first instance going to be dislodged monetarily from Asia, only militarily.

Crucially, the post-war unravelling of European Colonial Empires across Asia and Africa removed barriers for those with any ambition to 'take-over' resources across these continents and beyond. That China is taking advantage of this whilst India isn't, to me reflects favourably on the former and unfavourably on the latter.

Far from China being seen within them as exploiting the sovereign nation's it has targeted to buy ownership of resource assets, the sentiment towards it is invariably favourable. This is thanks largely to the considerable direct investment in infrastructure Beijing has and is making alongside its acquisition spree. This infrastructure serves national interests across Africa, Asia and wherever else it happens, whilst also benefiting China by making the resources it has 'acquired' more accessible and transportable. And unlike the not inconsiderable investment Great Britain made across the Colonial Empire of its day, the capital invested by China is ultimately being spent in nations which are truly sovereign.

I could go on and consider other important instances why China will not follow Japan’s path over an economic cliff but continue to climb ever higher. I will close by saying that Beijing should thank Tokyo for the help the latter has given it in navigating China’s economy by marking the rocks it not simply hit but invariably steered into. As for those who consider China's investments around the world as being on a par with European colonialism of its day, quite frankly they do not know how to distinguish historical context from current fact.

3. The world’s currency landscape: a singular lack of plurality, but not for much longer

I want to consider America's global currency hegemony, what Valery Giscard d’Estaing in the 1960’s when he was France’s Minister of Finance, complained was the dollars 'exorbitant privilege’. For in both being the near exclusive numeraire in the pricing of commodities to the most widely held currency in global savings the dollar and Treasuries enjoy considerable pricing power.

The dollar’s ‘exorbitant privilege’ will continue until and unless another currency emerges to rival it. This brings me to the IMF's “meta” or “basket” currency known as the Special Drawing Rights (SDR). Having missed the 2010 ‘cut’ for entry to the SDR, I cannot believe the RMB will miss it this year (I expect this to happen in Autumn/Winter 2015). And on being admitted to the SDR the RMB will find itself finally anointed as a world currency.

The IMF extending its SDR to encompass the RMB will be one clear sign that the dollars 'exorbitant privilege' is coming to an end. A number of other shocks will herald the end of its pre-eminence, notably as Central Banks around the world de-peg their currencies from it. Some see a US dollar peg as providing a crutch to hold a currency up. I disagree, and would claim a strict dollar peg is often a weight holding a currency down. And nowhere has this been more evident than in the Special Administrative Region of China, Hong Kong.

Despite Hong Kong being a SAR its dollar remains stubbornly pegged to its US namesake. The consequence of this is that over the past ten years the Hong Kong dollar has joined the US dollar in slipping in value by a third relative to the RMB. Let me reflect for a moment what this has meant for the people of Hong Kong. It has meant their assets have cheapened for mainland buyers, and it has meant that their cash on deposit has yielded much less if held in their own currency than if saved as the RMB. Moreover, Hong Kong's ability to be a source of funding across the region, its ability to in effect become a rentier, has been held back by its currency being pegged to the US dollar. Those defending Hong Kong’s currency status quo will point to the comparatively low interest rates and 'cheap money' which adopting a facsimile of US monetary policy has provided Hong Kong (chart 5). The issue here is that monetary policy should be tailored to a nation, just reflect again on the UK’s experience when it was shackled to the Bundesbank monetary policy until it broke from it on that fateful White Wednesday on September 16th 1992.

Of course there is a 'social' sensitivity to Hong Kong maintaining an 'independent' currency from China, an argument that the HKMA would be attacked - quite literally - if it made any attempt at shifting away from its long standing currency regime. My point is that the majority of the people of Hong Kong will recognise the good sense in such a change.

It is woefully naive for some in Hong Kong to believe that in keeping their currency pegged to the US dollar they are maintaining a semblance of independence from mainland China. The reality is that this strategy is misguided, allowing a stronger RMB to be a ‘Trojan Horse’ entering Hong Kong to overrun assets.

There are of course those claiming that rather than strengthen relative to the US dollar the RMB will devalue and so reverse the opportunistic capital flows from China into Hong Kong. Suppose the RMB were indeed to weaken against the US dollar. Because of its peg the Hong Kong dollar would in this case also strengthen against the RMB. This would make Hong Kong not only less competitive relative to China but all other neighbours whose currencies join China's in weakening against the US and HK dollars, hardly welcome one would think to such a mercantilist “City-state”.

Chart 5: Interest rate comparisons

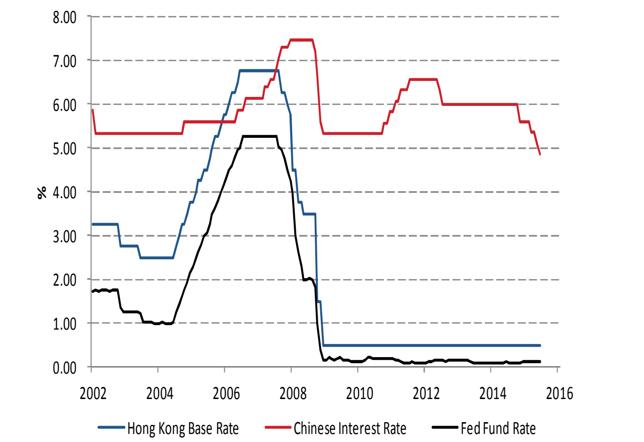
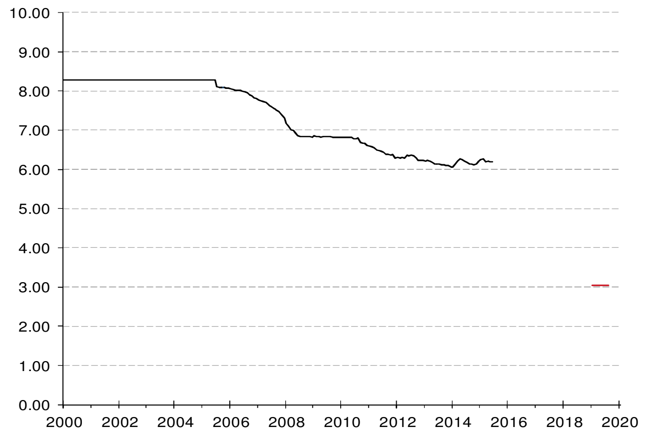


Chart 6: Yuan per US Dollar



Source: Bloomberg, HKMA, FED, PBC, Toscafund

Those anticipating that the US dollar will strengthen against the RMB justify this outlook by pointing out that the FOMC's monetary stance is on the cusp of tightening, whilst the PBOC is already actively loosening. These might like to reflect on the fact that a move higher in US rates will require a similar move in Hong Kong, hardly welcome to its consumers, borrowers, exporters and developers.

The incontrovertible fact is that the HKMA will inevitably and eventually recognise that its currency is best aligned not with the US dollar but China's RMB. Matters do not end here. There is an argument that Indonesia too needs to loosen the tight reins which link its Rupiah to the US dollar, and so should other Asian nations which have strict dollar pegs.

On the theme of 'Asian' currencies let me turn to the Australian dollar. It is no exaggeration to say this has taken a battering over recent years, making those fundamentally bullish towards it look rather foolish and poor guides to prospective moves in exchange rates. Well, if the strength in the RMB against the HK dollar has made assets in that SAR cheaper for buyers from mainland China, the RMB's strength against the Aussie dollar has been all the more generous. Those Australians who have long wished for a competitive currency have to accept the price paid has been Australian assets becoming all the more affordable for Chinese buyers.

I react to every downbeat story towards Australia by pointing to how fortunate it is in geography, demography and geology. It is quite frankly not only Asia's but one of the world's most promising economies and one day its currency will reflect as much. And I am convinced this realisation will be timed for when China’s currency becomes a recognised reserve unit, and its growth story is once again seen as being a sustainably robust one. On the latter note let me turn to China’s move to a new economic growth model one where far from stifling export growth because it undermines competitiveness a strengthening currency will allow a rebalancing towards greater internal consumer growth, all the faster as it receives inflows of capital not from export sales or Foreign Direct Investment (FDI) but Foreign Portfolio Investment (FPI). Those unconvinced this will happen might like to consider the recent liberalisation of China’s corporate bond market. In early May the People’s Bank of China approved HSBC, Morgan Stanley and thirty other foreign institutions to invest in its c$6trillion domestic bond market, the World’s third largest. This was part of a wider liberalisation under the Qualified and Related Foreign Institutional Investor programmes (QFII and QFII). Make no mistake the world’s central banks, sovereign wealth funds, and institutions running insurance and pension assets will look towards Chinese fixed income markets with a keen interest.

Let me spend a bit more time considering the currency outlook for China.

I have already made my view clear; the yuan’s direction of travel will be upwards. For its part the IMF is more ambivalent believing the yuan is no longer undervalued, a curious assertion when one considers China's considerable trade surplus (see chart 7). Against my view of it being 'cheap' and the IMF's that it is fairly priced, there are those convinced the yuan is overvalued. This is my understanding of the reasoning behind the view that the yuan will weaken against the US dollar. Yuan bears believe that Beijing will respond to economic weakness within China by cutting interest rates. The second string of the argument is that the FOMC will itself respond to improving economic conditions in the US by beginning to tighten. Now, I take no issue with the outlook that the People's Bank of China (PBOC) will continue to lower interest rates (having been cut by 0.25% on June 27th to 4.85%, and so leaving considerable scope for further moves – chart 5).

Chart 7: China trade surplus (bn USD) & foreign reserves

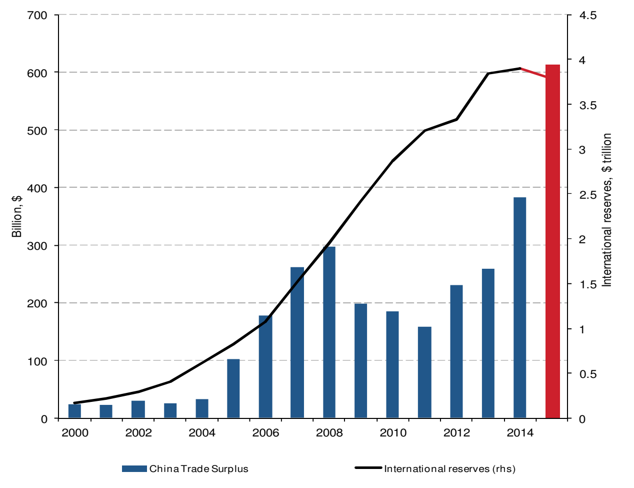
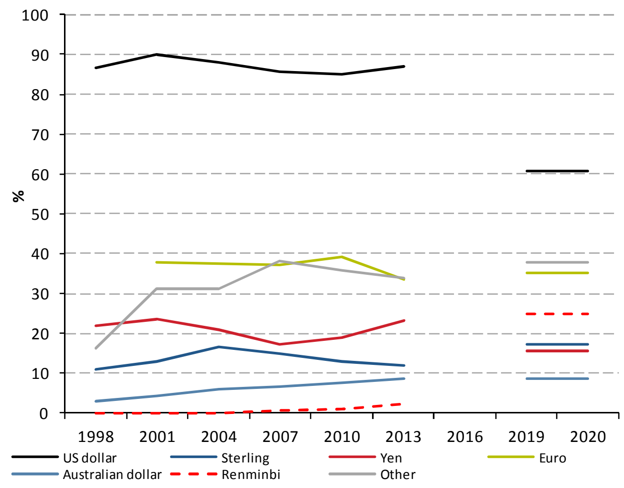


Chart 8: Units the world trades-in & forecasts



Source: IMF, Bloomberg, Toscafund

Note: Individual currencies sum to 200% as each currency trade is a part of a pair. Figures adjusted for local and cross-border inter-dealer double-counting.

Allow me to make my view perfectly clear. The PBOC's behaviour is perfectly justified. It should not be seen as a desperate measure, but rather a sensible response to inflation being tamed by sharply lower input costs, notably energy prices. The PBOC's loosening of interest rates within China should also be seen as a welcome stimulus to its economy.

Let us shift our focus to Washington and Federal Open Market Committee (FOMC). The same disinflationary/deflationary forces at work in China are in play across the United States. Indeed, if the yuan were to weaken against the dollar these disinflationary forces would build still further, calling into question the good sense of the FOMC lifting the Fed funds rate. Indeed, to those claiming that the PBOC's loosening of monetary policy is a desperate act in the face of China's economy 'hard landing', might like to reflect that the US itself cannot be immune to this. This is something which hawks within the FOMC will have to reflect on when calling for a rate rise. In effect the argument being put forward by yuan bears that the PBOC will loosen as the FOMC tightens is a *non sequitur*.

As important as the opening up of its corporate bond market is in encouraging capital inflows, I am convinced a far greater quantum of capital will be attracted by the looming issuance of Chinese sovereign debt. This will be no different from what others have done in the past, sell a part of their sovereign growth story to investors inside and outside their borders at a price which reflects confidence. For China I have every confidence there will be no shortage of international investors keen to own part of its growth, earning a far more generous yield than is available for most other high investment grade sovereign debt and owning and earning in a currency whose momentum is upwards.

At the beginning of this piece I mentioned the forces which I am convinced will end the 'exorbitant privilege' of the US dollar. Somewhat ironically, these very forces will increase the power of a great many Titan enough US corporates. The reality is that one significant by-product of a loss of majesty on the part of the dollar is the strengthening of the competitive edge of a raft of US industrial, consumer and technology firms. And to repeat whilst these are already behemoths they will only strengthen. There is Boeing and Caterpillar. There is Apple and there is Procter and Gamble. There is Disney and Intel. In fact I could go on and create a not insubstantial list. This global reach means almost all of the constituents of the S&P 100 earn more from markets beyond the United States than within it. And for this reason a move downwards in the dollar would translate – ceteris paribus - into an upwards move in corporate earnings. Indeed, in the event of the dollar giving up ground to the yuan in global savings this could well deliver to the US economy what Japan and the euro-zone have tried to engineer for their own economies; inflation. For rather than fear inflation the developed world is keen for it to return.

Let me close with these words. The way the world presently saves its wealth and the way it prices much of its resources shows a singular lack of plurality. And whilst it has lasted for some time this singularity cannot continue indefinitely. I would argue in fact that we are on the cusp of change, one which we would welcome. The catalysts for this change will be a pincer movement. From one direction the IMF in Washington will anoint the RMB into its Special Drawing Rights currency basket. From the other direction the PBOC in Beijing will take action to encourage ever larger flows of Foreign Portfolio Investment into China. There might even be a third force were the HKMA to be pro-active and change its anachronistic stance towards the Hong Kong dollar. If as seems most likely the HKMA reacts to events rather than leads them, it will simply widen the monetary gap between Hong Kong and China, something which will harm not help the people of the SAR.

4. Issue 32 – *False Chinese Whispers* (May 2015)

There is a famous apocryphal story relating to events in the trenches of WW1. Ahead of a crucial infantry charge from our lines, a message was relayed by word of mouth and from trench to trench. Legend has it that what began as "Bring reinforcements, we are going to advance" ended as "Bring three and four pence, we are going to a dance". From such a misunderstanding, disaster is certain to follow. And what I hear today from those claiming to be "fully informed" towards China's economy, seem no less tangled in misinterpretation.

I do not consider it an exaggeration to claim that the most important economic forecast of the moment is the one relating to China's future growth. Misinterpret this, then practically all others, across all continents, are misinterpreted. Interpret China "right" however, and the growth position of a great many other nations falls favourably into place. And of the great many number of nations whose fortunes are linked to that of China, Great Britain is the one which interests me most.

In what follows I will make the case why, for the foreseeable future, Beijing's authorities have plentiful capacity to manage China's growth at the impressive rate achieved over recent years. From this point I will try to explain why the economic fortunes of Great Britain promise to be so closely engaged with those of China and its growth "satellites". For the most part I will repeat my long-standing claim that the UK and China enjoy a high degree of propinquity despite their lack of proximity. I will also repeat that despite the UK being proximate to an economically troubled mainland Europe it not only does not risk being drawn into the latter's deepening troubles but will actually benefit as human and financial capital evacuate into it.

Let me begin then with why I have confidence in the sustainability of China's growth. Can I be clear at the outset; at some point China's economy will revert to a rate of growth much slower than it is currently recording. Indeed a point will be crossed when China will actually experience a reversal in its GDP. This accepted ahead of these two "points" and especially the latter, I have every confidence China will enjoy a great deal of growth. Why? Because when so many developed economies have essentially exhausted all conventional fiscal and monetary powers to deal with their growth headwinds, China has weaponry aplenty, compared to which the ECB's bazookas are mere pee-shooters. Beijing can lower interest rates, and it can spend its $4trillion of diligently saved reserves (chart 9). China has a capital account which it can open up and can issue sovereign debt to voracious buyers around the world (sovereign debt as distinct from off or on-shore corporate RMB debt). Indeed, let me turn to China's currency, a unit whose movement will provide favourable consequences in whichever direction it happens to travel.

Were the RMB to strengthen – as I expect it will – it will provide China with improved terms of trade, whilst also providing a dampener to inflation and a magnet for foreign capital, all contributing to the creation of a virtuous monetary cycle. If I am wrong however and the RMB were to instead weaken, this would improve China's competitiveness, something hardly unwelcome to its current account and ensuring China continues its recent mercantilist success. Let me now reflect for a moment on the RMB and why I am so confident it will continue to move ever higher – most notably against the US dollar - even as the PBOC loosens monetary policy. Rather than Beijing being the origin of the "shock" upwards in the RMB I am convinced it will be Washington where it originates.

An event which occurs every five years is taking place in 2015. Towards the end of this year the Washington based IMF will make its five-yearly review of its Special Drawing Rights (SDR). According to the IMF's own fact-sheet:

> *"The SDR is neither a currency, nor a claim on the IMF. Rather, it is a potential claim on the freely usable currencies of IMF members."*

At present the SDR is weighted broadly as follows: c42% for the dollar, and slightly less for the euro at c37%, with sterling on c12% and the yen c9%. The latter's weighting has been the one most "sacrificed" since 2000 as the euro's has increased. For its part the dollar's weight having slipped from the 44% it held through 2001/10 has recovered as the dollar itself has experienced relative exchange rate strength (chart 10). These weights do not of course reflect the reality of how this currency-quartet are used in settling global trade or for that matter allocated in the world's foreign reserves. The SDR is in reality (*sic*) a sort of Alice on Wonderland fiction for the world's currencies. This is of course no less "Alice in Wonderland-like" than the "G20" a grouping which includes Saudi Arabia AND the EU despite double-counting the latter because it includes its four largest members. This said, most understated of ALL in the SDR is the RMB, whose non-appearance woefully misses its ever greater global importance. The RMB is quite frankly a currency which can no longer be marginalised by the IMF.

Chart 9: China's trade surplus & its $ foreign reserves

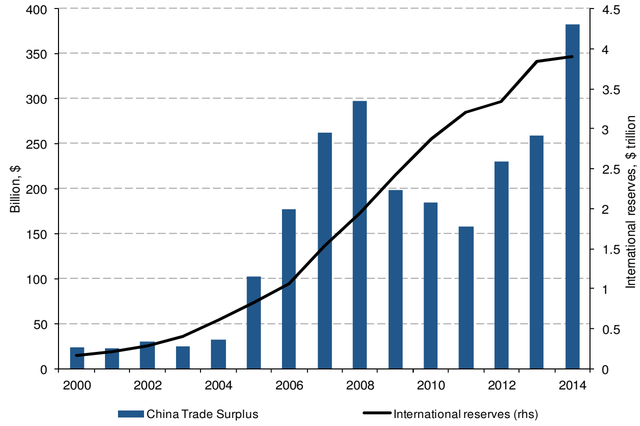
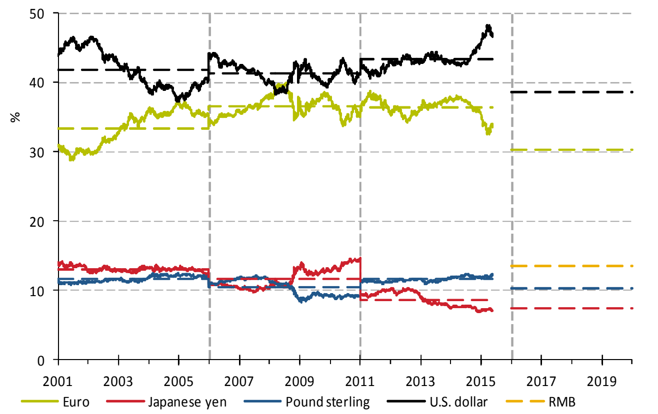


Chart 10: SDR weights, currency adjusted (with forecasts)



Source: IMF, Toscafund Note: Average 5-year forecasts include the inclusion of the RMB in the basket of weights for the SDR.

I have no doubt that having been ignored in 2010 when the IMF decided not to include it in the SDR, the RMB cannot be sidelined in 2015.

The RMB's initiation into the SDR from 2016 – in chart 10 I speculate on what representation it might take and how that of the existing quartet will have to adjust lower to make way for it - will formalise its role as a cornerstone reserve currency. In conjunction with the anointment of its currency, China's sovereign debt – as yet unnamed – can begin to be issued - and keenly acquired - around the world. As with the introduction of any "new product" there will be a considerable element of substitution from "old goods". With Chinese sovereign debt becoming "preferred" where Treasury's were the default purchase, the worlds monetary and currency landscape will change profoundly. If I am right the arrival of a powerful rival would have a dramatic impact on the US debt market, denying it the global demand it has become so accustomed to. The dollar's "exorbitant privilege" will, I am sure, be further eroded by the pricing of commodities being shocked away from its dollar *numeraire*. The dollar's position will be further undermined were the Hong Kong Monetary Authority to take the bold decision of moving the Hong Kong dollar away from a strict peg to the US dollar. The result of only one of these dollar "shocks" would of course be a shift up in US bond yields. Rather however than see a "rout" in the dollar as negative for the US we should see it for what it will provide; the medicine – bitter at first – for America's ills; the injection of a considerable dose of inflation. After all, the inflation injected into the United States economy would help monetise the still considerable debts – household and state - which have in large measure been kept at bay in part because of forbearance, in part because of zero-interest rates and in part because the dollar remains the world's staple reserve currency and the exclusive numeraire for the bulk (*sic*) of commodities. Remember much of the "developed world" is desperate for inflation; the euro-zone and Japan respectively struggling to forestall deflation and ignite inflation, with their expansive monetary programmes. For my part I see neither the ECB nor the Bank of Japan succeeding in their ambitions (the UK experiencing only a fleeting moment of deflation). As for those ruminating on Russia's economic fortunes, its will, like Britain's, turn on those of China, to which I now return.

To repeat Beijing has a sizeable cache of monetary and fiscal weaponry at its disposal to deal with any challenges China's economy might come up against. In addition to conventional fiscal and monetary tools I am convinced Beijing has unconventional ones it can employ favourably for China's economy. As well as fighting on economic fronts Beijing can achieve a considerable economic peace dividend on a diplomatic front close to home.

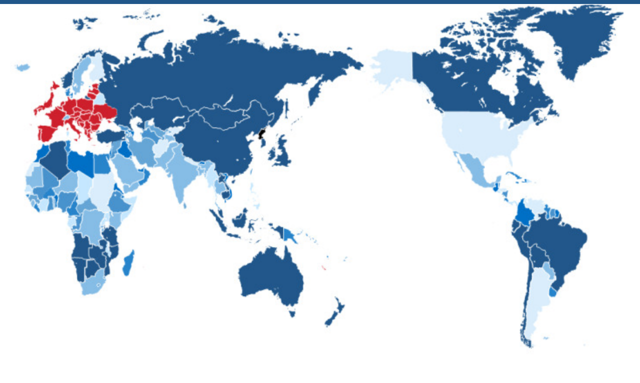
I have long held the belief that North Korea will experience a Beijing-led regime change. This could then easily move quickly into economic détente between the two Koreas. Despite remaining separate "sovereign" nations, I am sure that following a regime-change in the North the two Koreas will begin a rapid economic engagement, doing so not only on a denuclearised Peninsula, but a fully demilitarised one. For Beijing this would provide considerable dividends: economic, diplomatic and military, all of which I outlined in a dedicated Discussion Paper in late 2011. A détente on the Peninsula would also weaken the position of the US in the region and indeed Japan, consequences hardly unwelcome to China's leaders.

In short then, I see China as being an impressive economic growth story for some time to come, with considerable scope to manage its success on a number of fiscal, monetary and geo-political fronts.

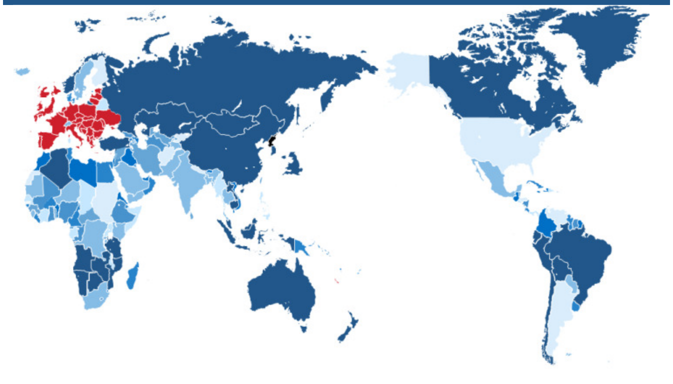
Assuming I am correct on China then how does the positive view on the UK link to this? Well, the answer is very simple, and to give it I will drawn upon the text of the Toscafund Economic Update just prior to this:

> *"When I look at the world I do not see it as it appears topographically but how it is economically, and map 1 is how I see Britain in a global economic and financial context.*

Map 1: A UNITED Kingdom’s economic topography



Map 2: England’s economic topography were it to EXIT



Source: Toscafund

> *As I have long argued we must not confuse geographic proximity with economic propinquity. And whilst Britain may nestle alongside Europe in terms of its physical proximity, given its economic propinquity with the likes of China et al, it might as well be over in Asia. Just reflect on Britain seeking to become a founding member of the Asian Infrastructure Investment Bank (AIIB), a move which no other "western nation" had the foresight to do until Britain had done so. Indeed the United States has expressed objections to Britain's inaugural keenness towards the AIIB, no doubt because it sees it as a threat to the hegemony of the Washington-based World Bank. Bear in mind too that China is now the largest single market for British-built cars after the UK, with almost 140,000 UK-made cars exported to China in 2014, a seven-fold increase in five years. Consider too the surge in Chinese students attending British, in particular English Universities and paying very generously for the privilege. This alongside London being by far the preferred Western hub for Chinese – indeed Asian wide – financial and business service companies confirms how Britain is very much a flourishing economy as much of Europe flounders. And whatever their ultimate ambitions, Scotland and the Republic of Ireland need to realise that economically their interests are best served joining England in engaging with a flourishing Asia (map 1). Their alternative is floundering with the rest of Europe (map 2)."*

Am I so smitten by China I am ignoring its challenges and so exaggerating Britain’s economic prospects? It is possible this is the case; possible yes but probable no. Why am I so sanguine? Because of the reasons I have presented above, reasons which are not imagined but real. There is the real potency for China to propel growth via a pro-fiscal economic policy and to propel growth via a looser monetary stance. There is even as I said the potential for Beijing to earn and spend a diplomatic dividend to grow the Chinese economy. And to repeat no nation across Europe and none indeed across the developed world, promises to engage more favourably with China than the United Kingdom. For not only will the UK benefit directly from China’s continued economic growth but thrive too through second order effects.

The raft of nations benefiting like the UK from China’s continued economic growth will send their children to study here, as well as travelling to our shores to vacation and spend their burgeoning wealth. These nations will follow China in opening up business hubs in Britain, drawn by its location, language and its increasing importance within a reformed EU. Matters do not end here. The impressive appellation of British motor cars will lift their assembly as domestic demand grows alongside Britain’s prime age population and as export demand strengthens, irrespective of sterling’s own strength. Throughout all this human and financial capital arriving into the UK will not confine itself to London, but spread widely across it. All the more remarkable is that I predict all of this would still happen even if we had seen a quite different electoral outcome on May 7th. I make this claim because Britain’s attraction to China is to my mind at least politically colour-blind.

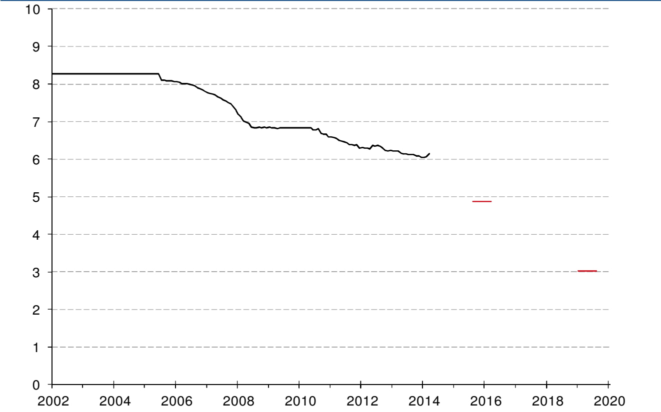
Let me close by hammering home a point by drawing upon the singular (*sic*) “Law of the tool”. This is best captured in an aphorism coined by Abraham Maslow; “It is tempting, if the only tool you have is a hammer, to treat everything as if it were a nail”. Whereas the challenge facing mainland Europe requires the use of supply-side instruments, the only tool available to the ECB is a monetary hammer, largely useless in providing the labour market reforms most notably France et al need. As for the authorities in Beijing they have a tool kit bursting with implements to use in building an ever larger Chinese economy.

5. Issue 25 – Beijing has its fx right (April 2014)

There are two facts that are undeniable. The first is that the level of China's currency is whatever Beijing chooses it to be. The second is that over recent weeks it has fallen and rested at a new level, a decline which has incidentally upset the US Treasury, which would like a stronger not weaker yuan. To those curious as to what Beijing is playing at with the RMB my answer comes in two parts. The first is that this is no game People's Bank of China is playing. Secondly, if it were a game, Beijing can be the only winner.

Chart 11: Chinese yuan per euro

Chart 12: Chinese yuan per dollar



Source: Toscafund

On Saturday March 14th the PBOC announced it would double (to 2%) the range the yuan could trade against the dollar around its daily mid-point "fix". Before this widening and for a period after, the yuan weakened (chart 12). Some have interpreted this as a sign of waning confidence towards the "China growth story". For my part I see it as nothing of the sort. Watching events I draw even more confidence over China's growth credentials.

That China remains dependent on funding its growth by being a merchantist economy is evidenced by its sizeable trade surplus (chart 13). And like any net exporter Beijing has been vigilant over the affordability of Chinese goods to its overseas customers. With this in mind the PBOC witnessed a currency sell-off in many of its large export markets. There was weakness in the Brazilian real, the Turkish lira, the Indian rupee, Ozzie dollar and the Russian ruble. Underscoring these bouts of weakness was a combination of "local difficulties" alongside the shared issue of taper-talk from Washington. Let me spend a moment on this "common factor".

Speculation and then actual efforts to rein in QE involved a technical correction in "yielding" currencies by reducing the carry earned from migrating into them cheap to fund dollars. Now I claim this is technical because in most (not all) instances the fundamentals of many high yielding currencies imply they have upside against the US dollar (chart 14). To complicate matters Russia, Brazil, Australia and Turkey have experienced more specific investor disquiet. For Brazil and Turkey confidence has been unsettled by an upsurge in unrest over political and economic management. For its part Australia has been the subject of concern over a reversal in the fortunes of its mining sector. In the case of Russia, confidence in its economy has been shaken by the possible impact of sanctions against it.

Now the competitiveness consequences of the events unfolding elsewhere was not lost on Beijing; hence its intervention to engineer a bout of weakness in the yuan.

Having already accepted that China remains keen to manage its merchantist growth, I want to repeat what I have written all too frequently in the past; China is poised to open-itself so that overseas capital can not only invest directly in its growth but do so via Sovereign debt. However to create Sino-Sovereign debt China needs a convertible currency, or at the very least one with more leeway than the yuan has had up until recently. Crucially then what we have seen from the PBOC is the killing of two birds with one stone. It has after all increased the yuan's manoeuvrability, essential for opening up its capital account. It has also engineered a competitive enhancing move lower in its currency, and to protect its current account surplus.

Now some will challenge my claim that China is progressing nicely and will no doubt cite its "shadow banking crisis" and its recent spate of corporate defaults. Whilst conscious of such matters, I would caution against exaggerating their importance. Of course there have been construction excesses and poor lending discipline. I do not however agree these will interrupt China's growth to any meaningful degree. Yes I accept that China's banks have extended credit unwisely. And I recognise that at some point they will have to come clean over these NPL's. I do not agree that its banks declaring this mea culpa will produce a monetary shock strong enough to derail China's growth. My reasoning for remaining confident in China's growth story (and why I am so attracted to an Australian economy that will capitalise on it) is that across a global economy where so many sovereign nations have become recklessly indebted to others, the Chinese State is a beacon of frugality and thrift, one yet to issue sovereign debt. When it does, and this day is drawing ever closer, there will be no shortage of keen buyers. I do not see it as an exaggeration to claim this will prove a momentous event, a catalyst for an entirely new phase of Chinese economic growth and a realisation that US Treasuries are no competition to their Chinese equivalent.

Chart 13: Chinas' trade surplus

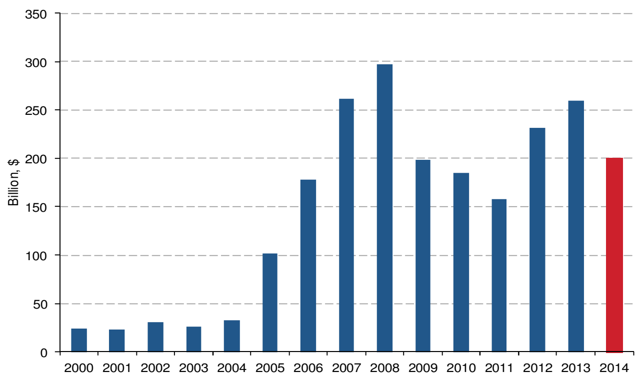
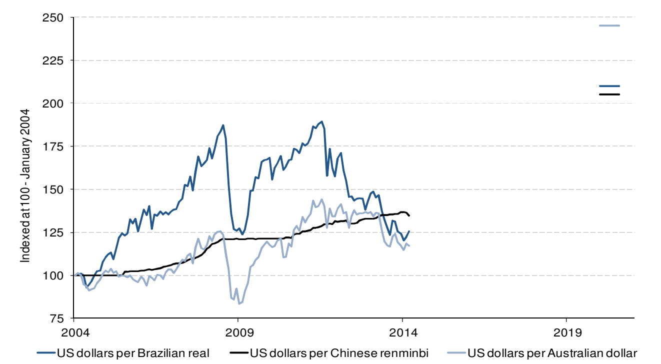


Chart 14: Brazil's real, the Aussie & yuan against the US dollar



Source: Toscafund

Some have speculated that Beijing has weakened its currency to punish carry-traders and other 'speculators'. I disagree. I view the motivation for Beijing's monetary intervention as its consideration of what is best for China's exporters (by stabilising the currencies of the New Growth Economies against the yuan) and what is best for China's internal demand (by lowering short-term interest rates). We should welcome the fact that its actions have achieved both ends as well as pouring cold water over hot money.

Let me return to concerns directed at China's "shadow banking sector". The name alone creates a sense of danger lurking in the semi-darkness. In reality however there is nothing unduly dark and sinister about it. China's shadow banking simply involves banks intermediating between where cash is plentiful across its corporate sector and where it is needed. And the simple fact is this is precisely what banks should do. Yes, on occasion credit and debt will be matched badly and non-performance and dereliction will follow. The idea however that China's particular problem is larger and more dark and sinister than across large tracts of Europe, the United States and more widely is quite frankly absurd.

In closing I would like to take a moment to grade a selection of the world's central banks, doing so according to my very personal perception of their competency in achieving a reasonable rate of real and nominal GDP growth in the years ahead. I define reasonable in the context of a balance in real, per capita and nominal economic growth and self-imposed inflation targets.

With my marking criteria in mind I believe the Bank of Japan will FAIL in at least one of its twin ambitions of kick-starting inflation whilst achieving real growth in domestic GDP, its worsening demographics at the root of its problems.

I also FAIL the ECB, in its case believing stubborn deflation will drag down growth in nominal GDP whilst compromising real growth, neither helped by euro strength, with the euro-zone's demographics working against things, just as they are in Japan.

I award a pass to the MPC, seeing the UK both remaining well within its target inflation range as its real GDP per capita expands in tandem with its population.

Moving to the FOMC, it too FAILS. Any sustained growth in US GDP will, I believe, only come about following a marked reversal in the dollar, a development which whilst igniting export sectors would also ignite inflation and harm domestic markets. This leaves the PBOC.

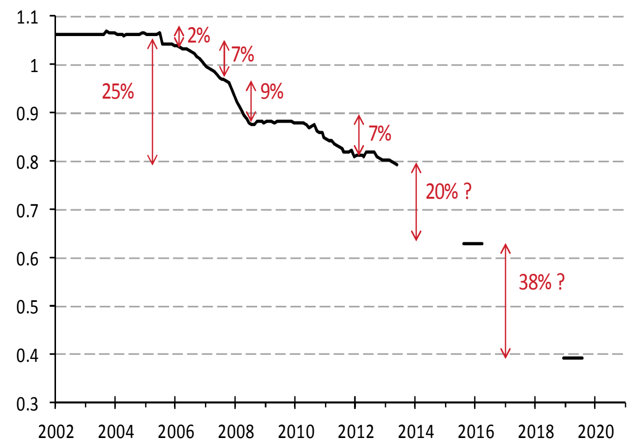
I award China's central bank not merely with a PASS, but a distinction in smoothly passing from a largely current account growth model to a more balanced capital inflow and trade mix. The PBOC's success will however contribute to the failures I anticipated earlier. For if it is indeed to successfully pass from an essentially mercantilist growth model to a more balanced one where the current and capital accounts provide surpluses for internal use this will require the PBOC to allow for greater currency convertibility so as to issue yuan denominated sovereign debt. The consequence for the United States is a rival for its treasury market and a near certain monetary shock, inflation up in tandem with yields. For the euro-zone the implication is a de facto competitiveness sapping move higher against the dollar. The reality is that in the global economy ahead it will need some to fail for others to pass.

6. Issue 20 – Hong Kong Matters (June 2013)

In continuing with the exchange rate realignment theme I would like to explore how much longer Hong Kong can continue to have its dollar “united” to that of the United States? The question is all the more pressing since China’s currency has been moving ever higher against BOTH (up by over one-third in fact since 2005).

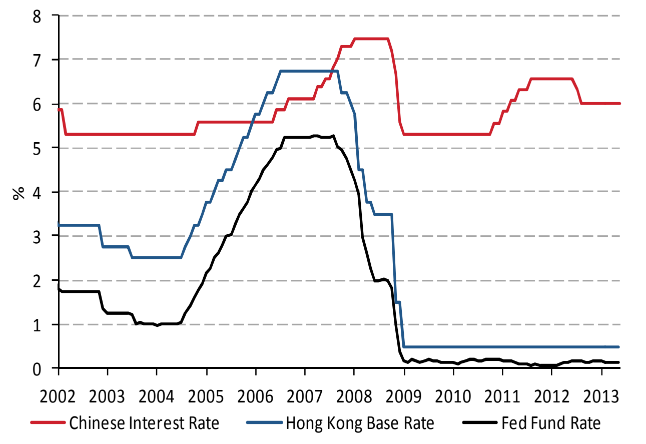
In chart 15 I show what would happen to the Hong Kong dollar’s exchange rate to the yuan were my forecast for the latter against the US dollar to be realised (chart 17). The Hong Kong dollar’s link to that of the US is quite frankly untenable; untenable because it is stoking considerable carry-trade combustion between Hong Kong and China proper which are essentially the same nation.

Chart 15: yuan per HK$ & POTENTIAL?



Source: Bloomberg, Toscafund - Note chart 14 forecasts based if peg not broken.

Chart 16: Interest rate comparisons



The financial world is of course full of exchange rates between two currencies that defy ‘fundamentals’. What we are seeing however in charts 15 and 16 is a carry-trade between Hong Kong dollars and the Chinese yuan which in monetary terms is becoming combustible.

To illustrate just how ‘combustible’ monetary matters are, imagine living and working in Hong Kong. On being paid each month you have two options: keep your money on deposit in Hong Kong dollars, earning derisory interest; or you transfer into a more generously paying yuan denominated account (chart 16). Not only do you after all earn more by making this transfer but your wealth is boosted with each move higher in the yuan against the HK dollar (chart 15). Matters do not end here however.

The way matters stand the incentive is to raise credit in Hong Kong dollars and carry this into Chinese yuan. The upshot of the Hong Kong dollar being united with the US dollar is a series of arbitrages that simply cannot continue, or rather can continue but not without Hong Kong becoming ever more disunited monetarily from China.

Whereas Hong Kong’s short-term interest rates are facsimiles of those in the United States their respective consumer price inflation rates are markedly different (chart 18). Moreover, inflation in Hong Kong is running ahead of that in China, and as long as the peg continues this gap will widen. In short, the HKMA has to recognise the yuan is the only appropriate currency the HK dollar should now be managed against.

Chart 17: US$ per yuan & forecasts

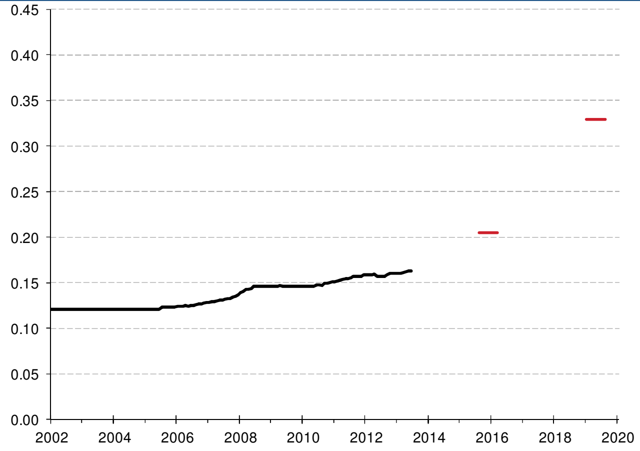
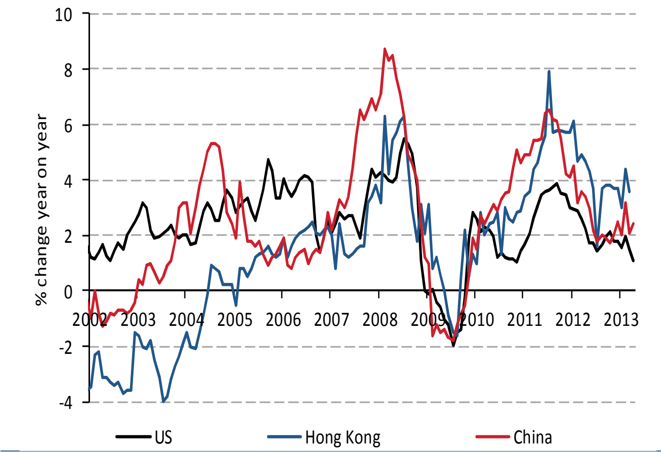


Chart 18: Consumer price inflation comparisons



Source: Bloomberg, Hong Kong Monetary Authority, Toscafund

Conspiracy theorists will no doubt claim the PBOC not the HKMA has ALLOWED the yuan to strengthen against the HK dollar so 'mainland Chinese' buyers can ever more cheaply acquire assets across Hong Kong; a sort of stealth or monetary takeover. They will continue with the claim the peg has been kept so as to allow Chinese borrowers to raise loans in Hong Kong dollars at a cheaper rate than achieved in yuan; loans moreover whose yuan value contracts with each step down in the HK dollar against it. Whilst I will not deny this carry-trading is going on, I view it as a consequence not a reason for the peg being held stubbornly where it is.

Beijing has long known that a shift in the HK peg from the dollar to the yuan would open it to the accusation of a different sort of 'monetary takeover'. Beijing may also reason that a 'relatively uncompetitive' Hong Kong always needed a period of currency weakness to 'monetarily normalise' with China proper.

Whatever the reason the reality is the Hong Kong dollar cannot continue to maintain the fiction of connectivity with the US dollar. It cannot because the yuan will continue on its unrelenting rise against the latter, and as it does will stoke ever more carry-trading into and out of Hong Kong. The simple fact is that something has to give.

When the HK dollar DOES break from the US dollar it will be a de facto appreciation against it AND – albeit less so – the yuan. The longer we wait for this repositioning to happen, the greater the incentive to own HK assets, and so the greater risk of 'bubbles' forming and inevitably popping. Some will even argue that a pop is all the more a threat because the HKMA will have to shift from mirroring interest rates set by the FOMC to those imposed by the PBOC; the former currently lower than the latter (chart 16). I would ask those arguing this differential is precisely the reason HK has remained dollarised to look into the future where rising US rates pass Chinese rates coming down.

One could extend the assessment that Hong Kong needs to break free from the US dollar to the Indonesian rupiah. Indeed, it is instructive to contrast how the HK dollar, Indonesian rupiah and other Asian currencies are being managed with how those across Central Southern and Eastern Europe are. In the latter case the anchor currency is the euro, against which I believe multiple currencies across Central and Southern Europe will devalue as the Continent's fault lines widen to a chasm. As much believing currencies of – once - emerging Europe are markedly overvalued against the euro, I see most currencies of emerging Asia as markedly undervalued against the US dollar. My point is that seldom have so many exchange rate realignments loomed. And whilst not the most significant the shifts I expect in the Hong Kong against the US dollar, and the Polish zloty against the euro will be the two most symbolic.

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