

Fixed Income Insights

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Politics—the key to understanding China's growth story

As China moves to a more monetary-based growth model, we expect the government will surprise many by meeting any challenges that arise with long-term, policy-based solutions instead of quick political fixes.

There's an old saying in the retail industry—so old, it predates the online retailing revolution—that the key to success can be summed up in three words: "Location, location, location." Something similar can be said about the key to understanding the day-to-day workings of China's economic and monetary policies.

It comes down to three words: "Politics, politics, politics."

In our analysis, those who fail to heed this mantra risk underestimating the profound shift in growth dynamics now taking place in China and its long-term implications for the country's currency, the renminbi (RMB), and for global capital markets.

A case in point was last month's fixing of the onshore currency, the CNY, at a lower rate to the US dollar by the People's Bank of China (PBOC).

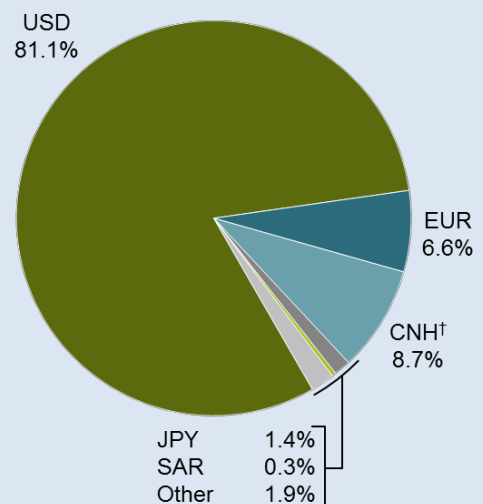
Those who saw the move as a deviation from what we (and most other observers) regard as the currency's secular appreciation should have paid more attention to the political angles, in our view. These are domestic as well as external.

Domestically, the overriding political imperative is China's commitment to economic reform—the transition from an export-led economy to one in which domestic consumption plays a bigger part. This rebalancing requires a flourishing small-to-medium size enterprise (SME) sector which, in turn, requires capital to be priced efficiently. In order to achieve this, China has embarked on several important financial reforms.

Chief among them is the internationalisation of the RMB as a prelude to opening up the country's capital markets. The increase in the currency's use to date has been remarkable: just over 20% of China's global trade is now settled in RMB and, last year, the currency overtook the euro to become the second most-used in the global letter of credit market (**Display 1**). Last month the RMB became the seventh-largest global payments currency, ahead of the Swiss Franc.

Display 1: Offshore RMB's Role as a "Trade Currency" Starting to Grow:

Letters of Credit (Value of Transactions)*



Historical analysis does not guarantee future results.

*Based on data year-to-October 2013

†Quick Development in 2 years

Source: ANZ Bank, PBOC Monetary Policy Report and SWIFT

The internationalisation strategy requires policymakers to maintain a steady profile for the currency in order to build confidence in it as its circulation continues to increase. The strategy includes a plan to widen the range within which the RMB trades against the US dollar. Such tasks are not made easier by the activities of currency traders and speculators who see the currency's rise as a one-way bet.

The evidence that last month's currency resetting was intended to shake out some of this speculative activity and reintroduce volatility into the RMB trade is persuasive, in our view. We believe there were three main targets:

- Exporters who "over-invoice"—that is, inflate the value of invoices, thus bringing funds into the country in a way that bypasses capital controls. The practice appears to have been the cause of a surprise 10% year-on-year spike exports in January.
- Chinese companies borrowing in the offshore US-dollar debt market in response to rising interest rates at home (another consequence of financial reform) and the RMB's appreciation, which underpins borrowers' perception of the ease with which they will be able to repay US-dollar debt.
- Entities (hedge funds, foreign banks selling RMB structured notes and companies) that have built positions in the currency options market by selling short-term USD/CNH volatility. Morgan Stanley estimates positions in these trades total US\$350 billion offshore.

As for the external political angles, the currency reset served as a reminder to China's international detractors that the country runs its own affairs. The timing, for example, came in the run-up to the scheduled April publication of the US Treasury's twice-yearly *Report to Congress on International Economic and Exchange Rate Policies*, which has previously criticised China for lacking flexibility and transparency in its management of the exchange rate.

The timing also sat well (from Beijing's perspective) with President Obama's planned visit to the region (Japan, South Korea, Malaysia and the Philippines) in April. The President's announcement last year of his administration's intention to make a "pivot" to Asia has caused some tension within the region, where China clearly aspires to become a leader.

The message about China's policy autonomy will resonate within Asia-Pacific now that the country appears, in our view, to be working towards becoming the region's liquidity provider in RMB, filling a gap in global dollar liquidity being created by the shrinkage of the US's current account.

Prepare for Some Surprises

To really appreciate the importance of the political dynamic in China's economic development, however, it helps to take a broader perspective. The China growth story to date can be seen largely in terms of the fulfilment of one policy objective after another, beginning with the open door policy in the 1980s.

A more recent milestone was the introduction of the offshore currency market in 2009 after the global financial crisis taught China a hard lesson about the disadvantages of having most of its trade denominated in a currency (US dollars) over which it had no control.

Since then, China has made many important innovations, such as the introduction of the Qualified Foreign Institutional Investor regime and its renminbi variant (RQFII), the experiment with shadow banking and, last year, the launch of the Shanghai Free Trade Zone and the announcement of the financial reform programme at the Communist Party's Third Plenum.

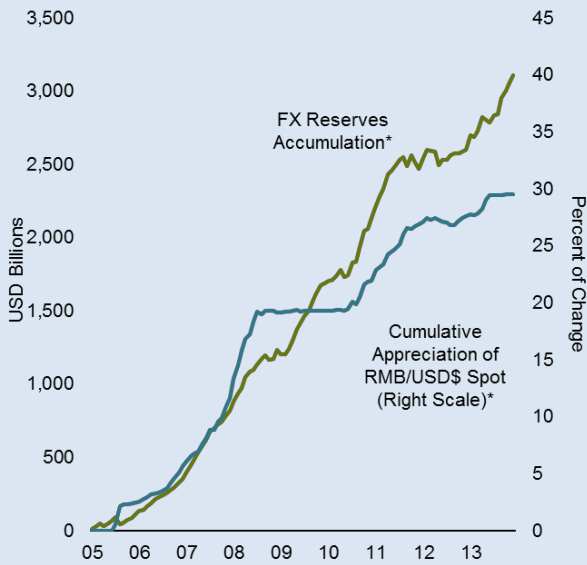
These are the achievements of a directed economy, and their success to date has fostered the perception of predictability about the China growth story. With the Third-Plenum decision to move towards a more monetary-based growth model, however, that story has changed; the only aspect of it that remains predictable is that the policymakers are still in charge.

Prepare for some surprises, in other words—such as, perhaps, the government allowing the default of a participant or a financial product in the shadow banking sector. For the last five years, the government has fostered the sector's growth as a spur to traditional banks to develop a credit culture capable of servicing the SME sector. Now, it's focused on regulating the sector to meet longer-term reform objectives.

We regard these four factors—politics, politics, politics and the move to a monetary-based growth model—as the key to understanding China now. In light of them, we believe that Beijing is prepared to sacrifice some economic growth this year to make room for its financial reforms to take effect. This was a key reason for our decision to downgrade our GDP growth expectations this year to 7.0%.

These four factors will also underpin the RMB's continued steady appreciation within a band of 1%-3% for the foreseeable future, in our view. We believe that the RMB remains undervalued, China having absorbed much of the appreciation pressure on the currency through its foreign-currency reserves (**Display 2, next page**)—which, this year, are set to top US\$4 trillion.

Display 2: FX Reserves and RMB/USD*



*As of December 31, 2013
Source: CEIC Data, Datastream and AllianceBernstein

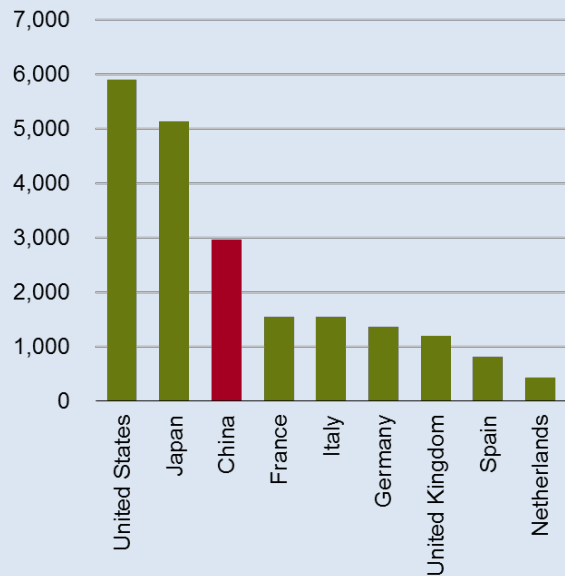
The country's trade and capital account surpluses have also been rebounding, putting more upward pressure on the RMB.

The bottom line is that China's progress towards becoming a major regional and global financial and economic power has not stalled, in our view, and may even be about to accelerate.

That's food for thought for benchmark-wedded global bond investors who have yet to reflect deeply on the implications—not the least of which is that, when China's government bond market (the third-biggest in the world, **(Display 3)** enters the global indices, investors will need to reallocate 12% of the portfolios simply to maintain a neutral exposure.

Display 3: Global Gov't Bond Markets:

The Top 10 (USD Billion)*



*Data as of December 31, 2013. Domestic securities on issue
China value taken as of September 30, 2013
Source: Asia Bonds Online, Asian Development Bank, Citigroup WGBI and BIS Quarterly Review, December 2013

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