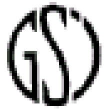


The Issues

June 1, 2011

RELEVANCE OF THE RMB OFFSHORE POOL IN HONG KONG

Hong Kong has evolved into the major financial center in offshore Rmb transactions. Chart 1 [Source: Monetary Authority of Hong Kong (HKMA)] shows the exponential growth in Hong Kong's Rmb deposit base, from nothing at the beginning of 2004 to over Rmb400 billion (US$61.5 billion) at end March 2011, a size equivalent to 13% of the total local, currency-denominated deposit base in Hong Kong. Just released April data shows a monthly jump of Rmb110 billion!

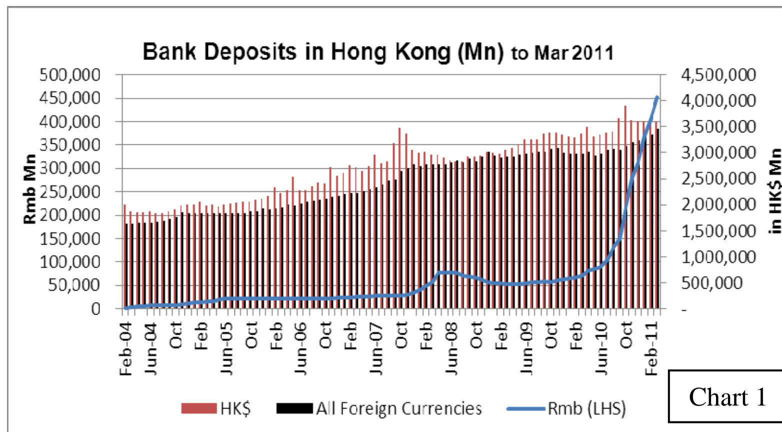


Chart 1

Chart 1 shows total deposits in Hong Kong in HK dollars and all foreign currencies. Two-thirds of the latter is in U.S. dollars, and the rest in other foreign currencies, with Rmb deposits at nearly 14% of the total.

A Short History on Rmb Deregulation

In February 2004, the People's Bank of China allowed the launch of Rmb business in Hong Kong. That relaxation meant Rmb cash spent by mainland Chinese tourists was allowed to stay in Hong Kong instead of being compulsorily returned to China via clearance banks.

Over subsequent years, growth of the Rmb pool in Hong Kong remained slow due to limits on the amount of Rmb cash individual tourists from China could legally take out of the country. By June 2010, the amount of Rmb in Hong Kong was less than Rmb90 billion. Restrictions were placed on how much Rmb each individual in Hong Kong could buy daily (a regulation that still exists). Companies are not allowed to buy Rmb in Hong Kong, and Chinese companies have to comply with strict approval procedures to send Rmb to Hong Kong for investment.

In 2009, cross-border trade among Shanghai, four cities in Guangdong province and Hong Kong was allowed to be settled in Rmb as test cases. In February 2010, banks in Hong Kong were allowed to determine the use of their Rmb funds as long as it did not involve the flow of Rmb back to the Mainland. In June 2010, cross-border trade settlement was expanded to 20 provinces and municipalities in Mainland China and to all countries and regions overseas.

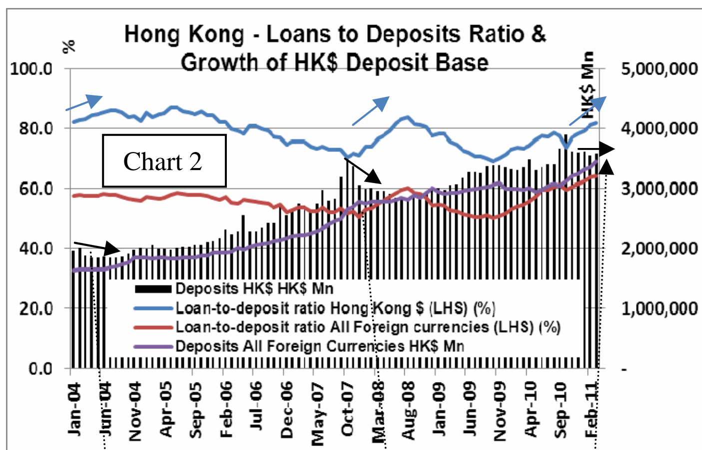
On July 19, 2010, the most significant relaxation took place. Interbank Rmb business was allowed in Hong Kong and no limits were placed on Rmb exchanges by companies in Hong Kong. Since then, the Rmb pool in Hong Kong has ballooned five-fold, from Rmb90 billion to Rmb450 billion by end March 2011.

Source of Substantial Rmb Fund Inflow

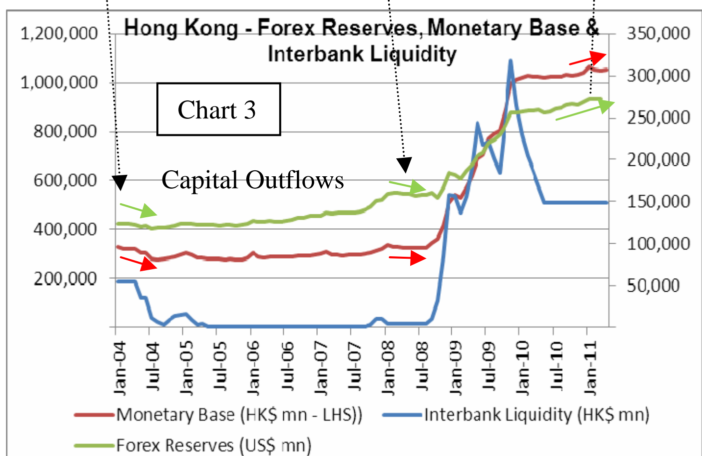
The relaxation of Rmb restrictions is structured to facilitate cross-board trade denominated in that currency. How big is trade between Hong Kong and China?

Hong Kong total exports (domestic + reexports) to China in 2010 totaled HK$1,598 billion (Rmb1,340 billion) and imports from China totaled HK$1530 billion (Rmb1,283 billion). In other words, Hong Kong net exported ~Rmb60 billion per year to China, which should be the level of annual net inflow of Rmb into Hong Kong (plus tourism receipts and approved foreign direct investment from China)—if export/import trade transaction-related fund flows were strictly adminstered and practiced by all parties. However, actual growth of the Rmb deposit base in Hong Kong was Rmb360 billion in the nine months to March 2011!

Two more conduits for Rmb inflow must have opened up: (1) Hong Kong firms can invoice exports to China in Rmb, the Rmb receipts are kept in Hong Kong and import needs funded out of HK or U.S. dollars (in short, the use of trade transactions to shift capital flow into Rmb); and (2) the use of faked import invoices by Chinese companies using affiliated entities in Hong Kong to send Rmb to Hong Kong to buy property and other assets in Hong Kong.



Not Much Evidence Yet



The Relevance

Conduit (1), the use of HK and U.S. dollars to pay for imports (the re-exports to China), results in capital outflows of HK and U.S. dollars. Under the dollar peg monetary system, such outflows shrink the HK dollar deposit base and reduce liquidity in the banking system.

On the other hand, conduit (2) creates net capital inflows into Hong Kong (from China). The process can add to the level of foreign exchange reserves held at the HKMA against which the HKMA issues Exchange Fund Bills and Notes. The latter expands the monetary base of Hong Kong and adds to bank liquidity.

The Records

Charts 2 and 3 (Source: HKMA) show how capital outflows due to global uncertainties in 2004 and 2008 shrank forex reserves and the monetary base in Hong Kong, which led to absolute declines in total bank deposits.

From September 2010 to March 2011, total local currency bank deposits in HK were basically flat (aside from an odd, one-month blip in October when a HK$230 billion rise over September was followed by a fall of slightly greater magnitude in November). Both forex reserves and the monetary base rose slightly. This would suggest locals have not shifted HK and U.S. dollars of size into Rmb. Lack of loan growth since Oct 2010 is probably a bigger contributor to the flat trend in HK dollar deposits.

The Main Contributor—Fund Flows from China

These figures therefore strongly suggest that much of the buildup of Rmb in Hong Kong has come from Rmb remittances from China (disguised as trade-related transactions, conduit (2), to pay for asset purchases of various kinds in Hong Kong. This has been one of the key factors driving bubble-like property prices in the territory. The over Rmb400 billion deposits held at banks exclude Rmb held by banks for their own accounts. And according to HKMA, two-thirds of Rmb deposits are held by companies, a fact compatible with fund flows driven mainly by business entities.

Capital Controls in China? What Capital Controls?

The surge in Rmb funds into Hong Kong disguised as trade-related transactions is another example of how Chinese entities have been making a mockery of China's capital control regulations. Concurrently, other Chinese entities are driving vast sums of hot money *into* China, which contributed to the buildup of US$200 billion of forex reserves in 1Q11 (~4% of GDP). The bulk of that is portfolio flow of hot money. China ran a small trade deficit in 1Q11, and foreign direct investment and other current account receipts from tourism, etc., could not have accounted for a jump of this magnitude.

A State of Economic "Anarchy"?

Using "anarchy" as an analogy, a series of signals have indicated that the central government's macro policy tools have lost control over major areas of monetary and fiscal matters. The first major evidence was the credit explosion, with cumulative net credit creation amounting to nearly 60% of annual GDP over 2009-10. What happened here?

Historically, annual credit extension targets and loan quotas, when needed, were the main tools of monetary policy. Up to 10 years ago, it worked fine on the whole. Communist Party cadres in banks, local governments and SOEs followed directives set by the Politburo. But since the departure of Zhu Rong Zi, and decentralization that yielded greater authority to local levels, actual loan extensions have overshot annual targets increasingly each year since 2002. Thanks to loan quotas, borrowers in China grab whatever bank credit they can during the first half of each year because by 3Q, near certainty exists that actual lending will have already overshot annual targets.

Despite years of talk about banking industry reform, no macro market supply/demand-driven mechanisms have been introduced to manage monetary policies. When the central government panicked in 2H08 in the face of the global financial tsunami and turned the credit taps on, those at local levels went on a credit extension binge—hence the credit

explosion. By 2010, despite macro talk of restraint, very few down the hierarchy ladder of the governing Communist Party followed directives from the top as credit creation stayed high. The creative ones formed investment trust companies to generate off-balance sheet loans. Credit created in this manner is estimated to be up to 15% of officially announced total bank loans for the whole of 2010.

Aside from the above-discussed issues with runaway credit creation and capital flows, other sectoral evidence of economic imbalances exists. There are a number of examples but take Ordos, Inner Mongolia, as one.

This city, population 1.5 million, boasts the highest per capita GDP of US$20,500 p.a. in China, a GDP of US$30.8 billion! Why? Thanks to coal. China's coal output is three billion tons p.a. At an average price of ~Rmb650 per ton in 2010 and a profit margin of, say, Rmb300, the coal industry makes Rmb900 billion in profit a year (US$138 billion), most of which goes into the coffers of mining bosses and close associates of officials running the few major coal mining provinces in China. The price of coal, an essential energy source for over 1.3 billion citizens living in China, is thus at the mercy of the coal oligopoly power base of a few provincial governments. China is in need of a major natural resources tax overhaul, but it appears the central government is powerless to implement one.

The Chinese Communist Party (CCP) at a Crossroad
Liberals within the CCP have dominated politics for the past 10 years, while the conservatives and hardliners took a back seat. In the name of economic liberalization, decision making was increasingly decentralized. But economic liberalization has advanced far ahead of progress made on regulatory and legal reform. Abuse of power and corruption among cadres are generally widespread. Data collection for monitoring and auditing sytems remains outdated, not having changed much since the 1980s. *Implementaton* of macro economic policies has gotten increasingly difficult for the central government.

By now, the top leaders must be well aware of the increasing difficulty to get cadres at the local levels to follow directives. A main issue, one that must be being hotly debated currently within the Politburo, is the fundamental issue of how the CCP should manage its 75 million members. Compound income growth at double-digits over the past decade have helped to elevate the feel-good factor of the public. But will discontent over corruption and abuse of power rise if growth slows? This is why the Politburo is so ultra sensitive to dissidents and activists. They draw public attention to the ineffectivenss of the CCP in managing its cadres and of the country's economic managers.

We do not know how the political saga within the CCP will play out, but clearly they have some soul searching to do. China's economy has enjoyed growth at an amazing rate of 10% p.a. compounded for the last decade. General market concensus is that strong growth will continue, after a pause. But we see China at a juncture, facing many challenges over coming years, chief of which are much needed reforms to strengthen the country's regulatory and legal infrastructures, and monetary and fiscal management.

Conclusion and Investment Policy
Up to 2004 growth was driven by fixed investments and exports (the catalyst which propelled the fast growth of the coastal provinces). From 2004, the central government undertook a conscious political policy to lift rural income to address widening income disparity (the rural sector having lagged in growth for over 10 prior years). Rural wages have surged double-digit p.a. compounded since. While that policy has raised the feel-good factor for hundreds of millions of rural folks, productivity gains have lagged and that sowed the seeds for the nationwide cost-push inflation China is now facing. The era of double-digit gains in income should be due for a pause, the limitation being productivity gains.

An adjustment period will come because inflation is likely to stay high (the result of the above factors) and that, coupled with politics from the changeover of new teams of economic managers from the central down to the local levels, will eventually drive a meaningful slowdown in credit creation. That process has probably started.

Our funds have cash in the low-teens at present. Markets have been discounting an economic slowdown in the U.S., as well as a potential restructuring of PIG debt. What may transpire in China has yet to be discounted, but a slowdown will lower commodity prices in general, which is positive for reducing inflation. At the same time, the relative attractiveness of ASEAN markets will shine more. That subregion of Asia remains our main area of investment focus.

The Net Asset Values GSI Asian Capital Growth Fund—US$27.93 & The Long/Short Fund—US$25.16 (May 26, 2011)