THE GREAT CHINA INVESTMENT HUB

REBALANCING CHINA'S NET INTERNATIONAL INVESTMENT POSITION

The role of Global Public Investors and international financial institutions in Sino-European economic relations

David Marsh, OMFIF Managing Director, Shanghai Forum, 27 May 2017

Global Public Investor is available in 2014, 2015, 2016 and now 2017 editions

Annual publication recording assets and performance of 750 public sector investment institutions (central banks, sovereign funds and public pension funds) around the world

Launch of GPI 2017 in London 14 June 2017

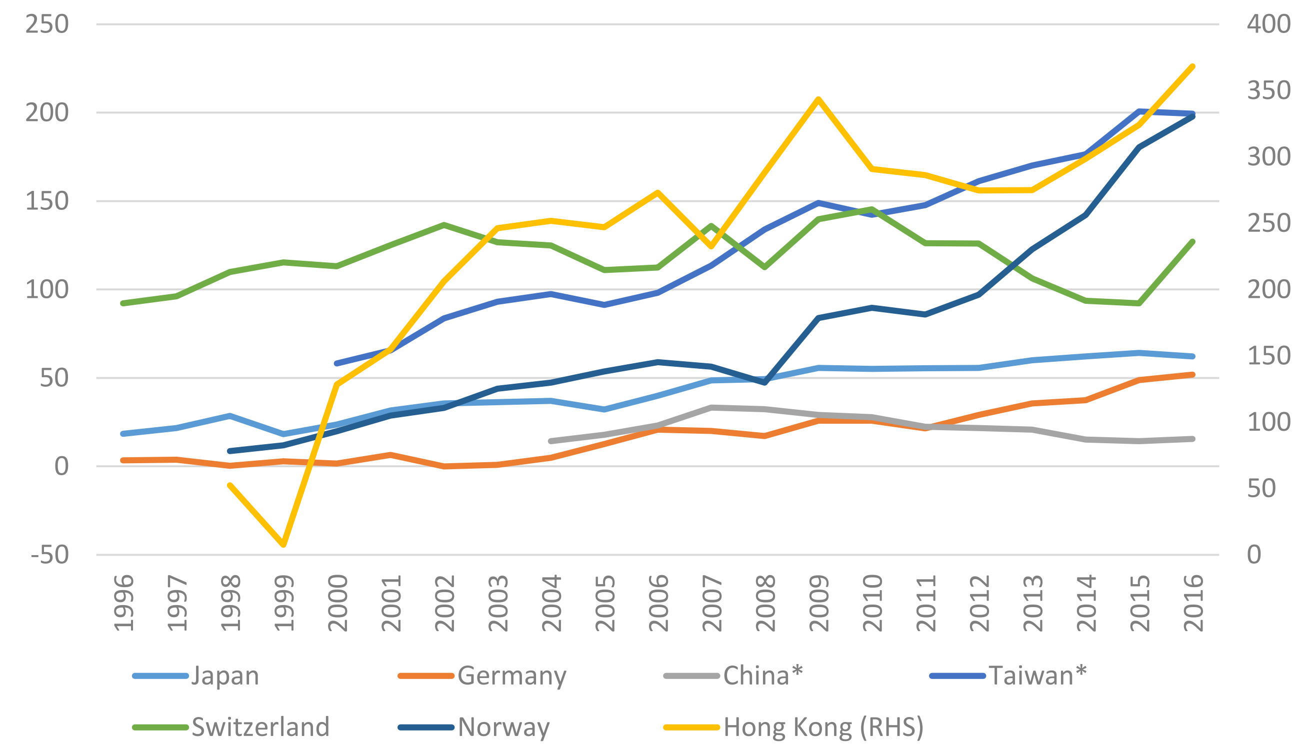
GPI Green Finance seminar, Frankfurt 13 July 2017

The Great China Investment Hub – Rebalancing China's NIIP

- China - second largest world economy, will almost certainly become the largest.
- World's biggest importer of many commodities, biggest exporter of various categories of manufactured goods – all this can be better secured through a process of renminbi-isation in international trade and investment relationships geared to judicious diversification of portfolio and direct investment
- Third biggest net foreign creditor – making a determined effort to rebalance Net international investment position away from dollar debt towards non-dollar (and renminbi) equity
- GPIs across the world are important players in this rebalancing
- Pooling of experience among the diverse bodies investing in China – including Bank of England, Magyar Nemzeti Bank, Swiss National Bank, Austrian National Bank, Banque de France

China is third largest creditor, with NIIP 16% of GDP (Germany 52%)

Net international investment position of largest creditors, % of GDP



Source: IMF, OMFIF analysis. Note: Taiwan and China data is latest 2015

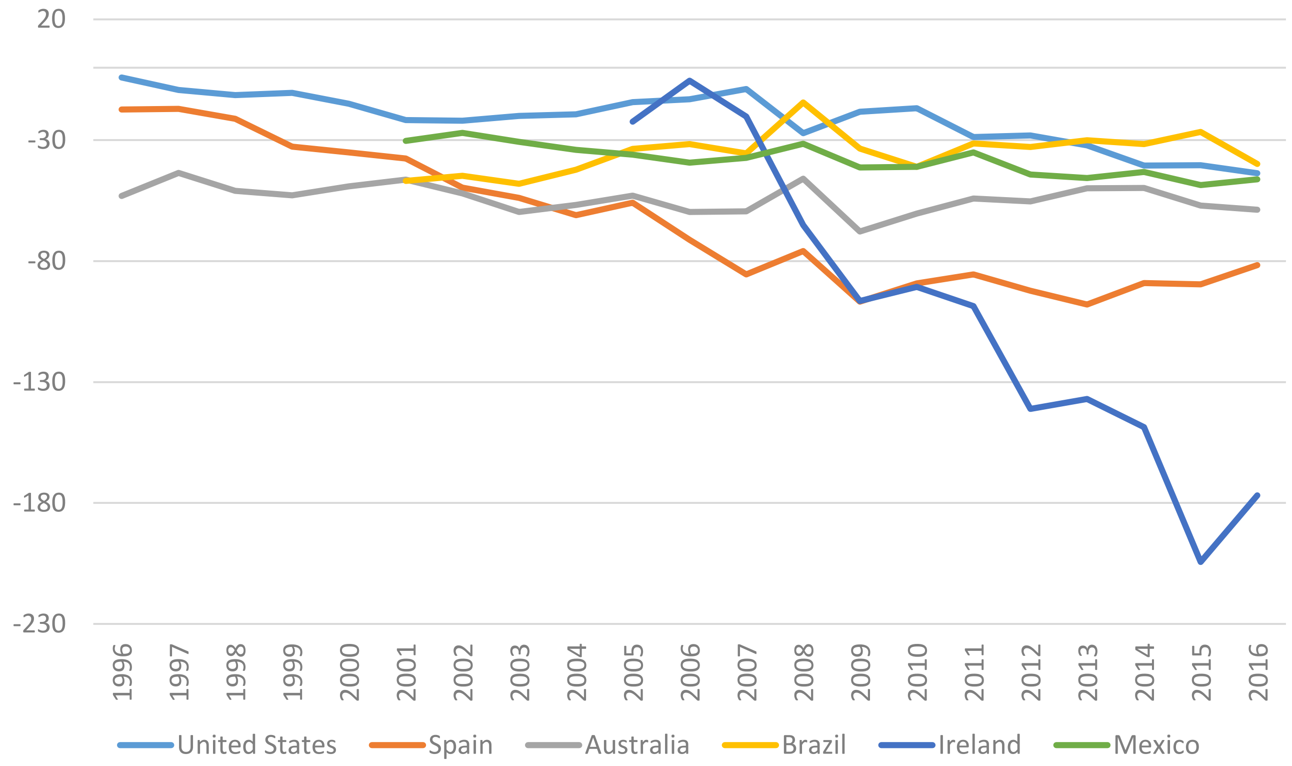
	NIIP ($bn)		NIIP (% of GDP)		GPI assets ($bn)	% of Top 750
	2016	2015	2016	2015		
Japan	3067.3	2815.4	62.1	64.2	3005.4	9.0
Germany	1797.3	1642.1	51.8	48.8	288.6	0.9
China	1747.1	1596.5	15.6	14.2	4199.5	12.5
Hong Kong	1180.7	1003.1	368.2	324.2	396.3	1.2
Taiwan	1053.9	1053.9	199.4	200.7	580.1	1.7
Switzerland	839.3	618.6	127.2	92.2	954.9	2.8
Norway	732.5	698.0	197.7	180.6	1007.8	3.0

Source: IMF, GPI 2017, OMFIF analysis

Chinese public investors hold over 12% of Global Public Investor assets ($4.2tn) split among four institutions.

US remains the largest debtor country

Net international investment position of largest creditors, % of GDP



Source: IMF, OMFIF analysis.

	NIIP ($bn)		NIIP (% of GDP)		GPI assets ($bn)	% of Top 750
	2016	2015	2016	2015		
United States	-8109.7	-7280.6	-43.7	-40.4	6635.35	19.8
Spain	-1005.7	-1069.2	-81.6	-89.6	79.7	0.2
Australia	-738.9	-701.6	-58.7	-57.1	533.5	1.6
Brazil	-716.6	-477.7	-39.8	-26.5	565.3	1.7
Ireland	-519.3	-579.5	-176.9	-204.4	26.9	0.1
Mexico	-482.2	-558.5	-46.1	-48.5	340.0	1.0

Source: IMF, GPI 2017, OMFIF analysis

The US holds almost 20% of total global public assets ($6.6tn) spread over 202 institutions.

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High stakes in China's liberalisation

- China's financial markets remain heavily regulated and underdeveloped and its capital account is not fully open. However, in both cases, there has been substantial reform

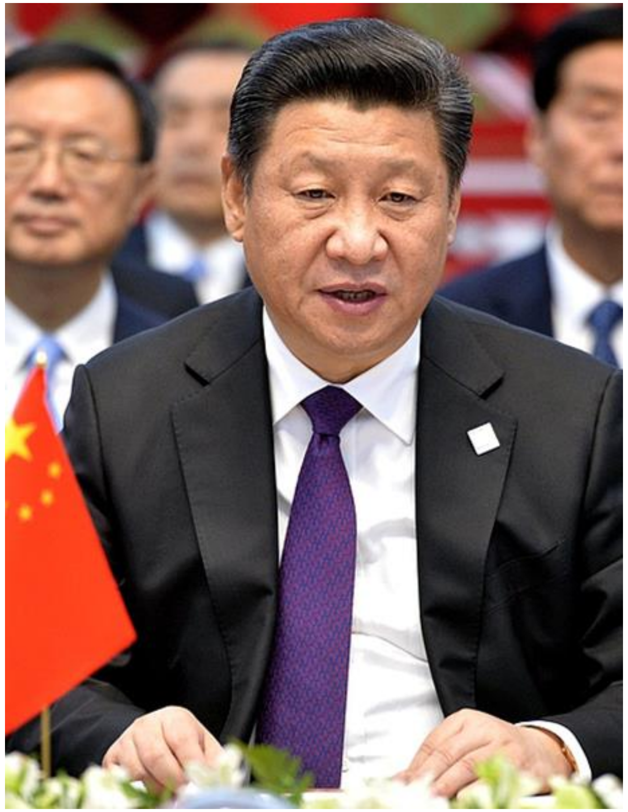
- The authorities will remain committed to 'managed' liberalisation - capital controls can reappear if justified politically – these considerations take precedence over pure economic interest in fewer controls

- If properly managed, the benefits of liberalisation greatly exceed the disadvantages. But if it goes wrong there would be political and economic turmoil

China getting both help and hindrance from US

Trump's fluctuating statements give China opportunity for 'China first' policy – America will almost certainly change course once it realises this gives Beijing major opening

'Protection will lead to great prosperity and strength'



'We must promote trade and investment, liberalisation and facilitation through opening up – and say No to protectionism'

China’s role in a multicurrency reserve system

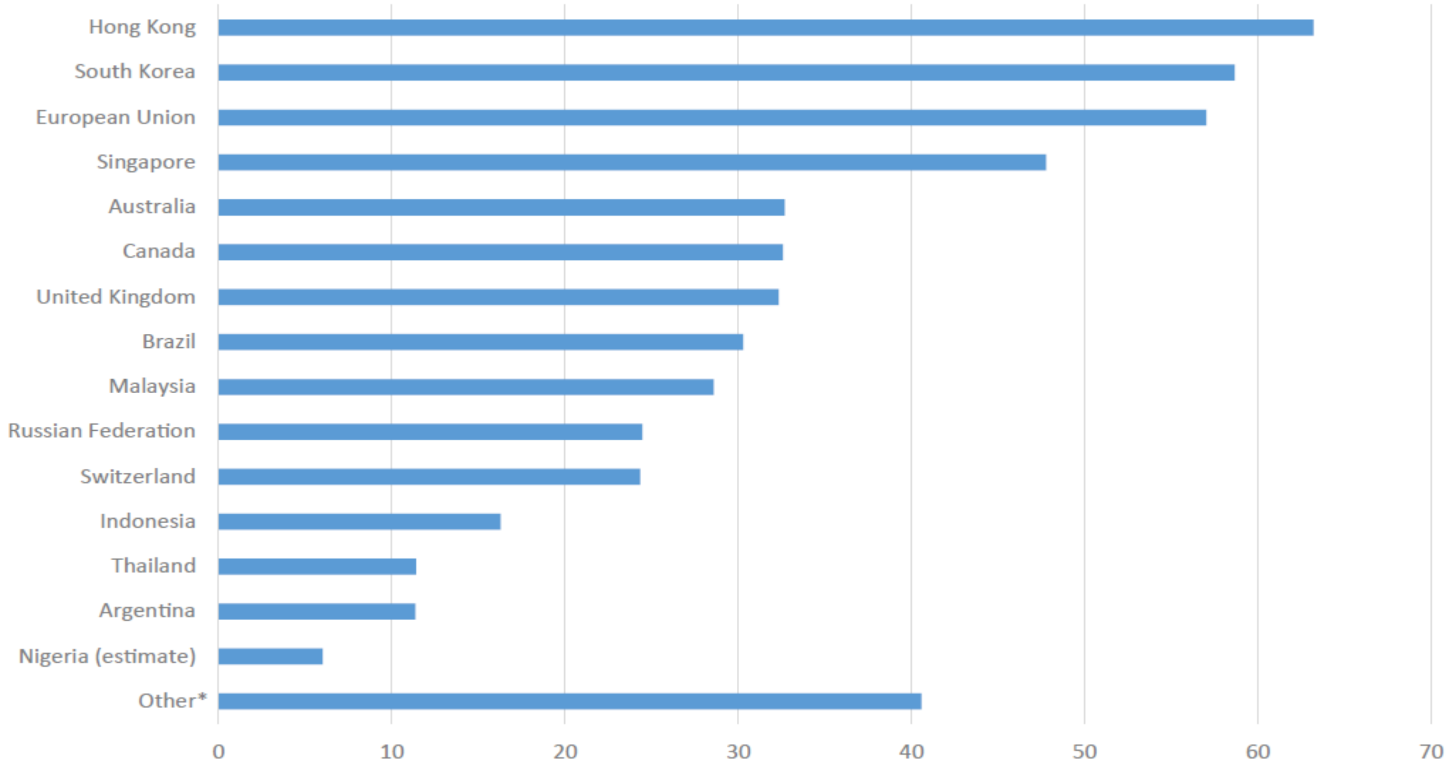
- World heading for a multi-currency reserve and transaction system, renminbi with important role
- Dollar dominant for foreseeable future, renminbi growing, long way behind
- Bumpy ride – shocks, turbulence and fluctuations among leading currencies
- China needs more exchange control liberalisation, capital market flexibility/depth, investor trust
- Progress on resolving discord over trade and investment with Trump administration will be crucial
- China doesn’t have to run current account defect to preside over significant reserve currency
- Main criterion: China allows foreign investors access to its domestic capital markets
- Despite ‘managed’ capital account, China becoming a significant hub for capital in- and outflows
- US Treasury’s decision not to brand China ‘currency manipulator’ encouraging sign of common sense
- PBoC’s $1tn reserves fall since 2014 high - intervening to strengthen, not weaken currency

GPIs' role in China asset-liability balance

- GPIs play a role in China asset-liability balance in several different ways:
  - Chinese investors – state and private - active in overseas markets, especially in build-up of equities to overcome perceived debt-equity imbalances
  - Three big China GPIs – People's Bank of China/SAFE, China Investment Corporation, China Social Security Find – account for 12.5% of world AUM ($35tn) on OMFIF GPI list
  - China spotlighting investment in Europe to build technology base, offset US antipathy over American investment, sidestep some restrictions on possible 'dual use' technology
  - International renminbi swap network a factor in China balances – US unlikely to join
  - European and other GPIs investing in China to diversify reserves, secure strategic advantage. This includes central banks, pension funds and sovereign funds
  - China opening up bond market to foreign investors , in a bid to offset capital flight and mitigate against weakening currency
  - Possible role for European and other GPIs in Belt & Road initiative, AIIB and other bank cofinancing – depends on build-up of ties between institutions in Europe and China

Asia leads renminbi swap network

China bilateral swap lines, $bn, 2016



Source: PBoC, OMFIF analysis

Countries with low reserves and which have no or limited access to global debt markets owing to poor ratings would be able to ease balance of payments pressures by drawing under the currency swap agreement. In such cases, those countries could maintain stable reserves under the watchful eyes of rating agencies. Thanks to renminbi liquidity through the swap line, Pakistan has been able to meet the conditions of net international reserves targets under the IMF facility.

China’s top GPIs in international comparison

2017 Rank	Change from 2016	Institution	Country	Region cod	Type	2017 assets $bn	2016 asset
1	0	People's Bank of China	China	AP	CB	3097.66	340
2	1	Government Pension Investment Fund	Japan	AP	PF	1334.68	115
3	-1	Bank of Japan	Japan	AP	CB	1216.52	123
4	0	Norges Bank Investment Management	Norway	EU	SF	923.80	95
5	0	Abu Dhabi Investment Authority	United Arab Emirates	ME	SF	828.00	79
6	0	China Investment Corporation	China	AP	SF	813.76	74
7	1	Swiss National Bank	Switzerland	EU	CB	678.91	60
8	2	Military Retirement Fund	United States	NA	PF	600.58	544
9	0	Kuwait Investment Authority	Kuwait	ME	SF	592.00	59
10	1	Federal Employees Retirement System	United States	NA	PF	557.9	52
11	-4	Saudi Arabian Monetary Agency	Saudi Arabia	ME	CB	547.87	62
12	1	National Pension Service	Korea, Republic of	AP	PF	[illegible]	[illegible]

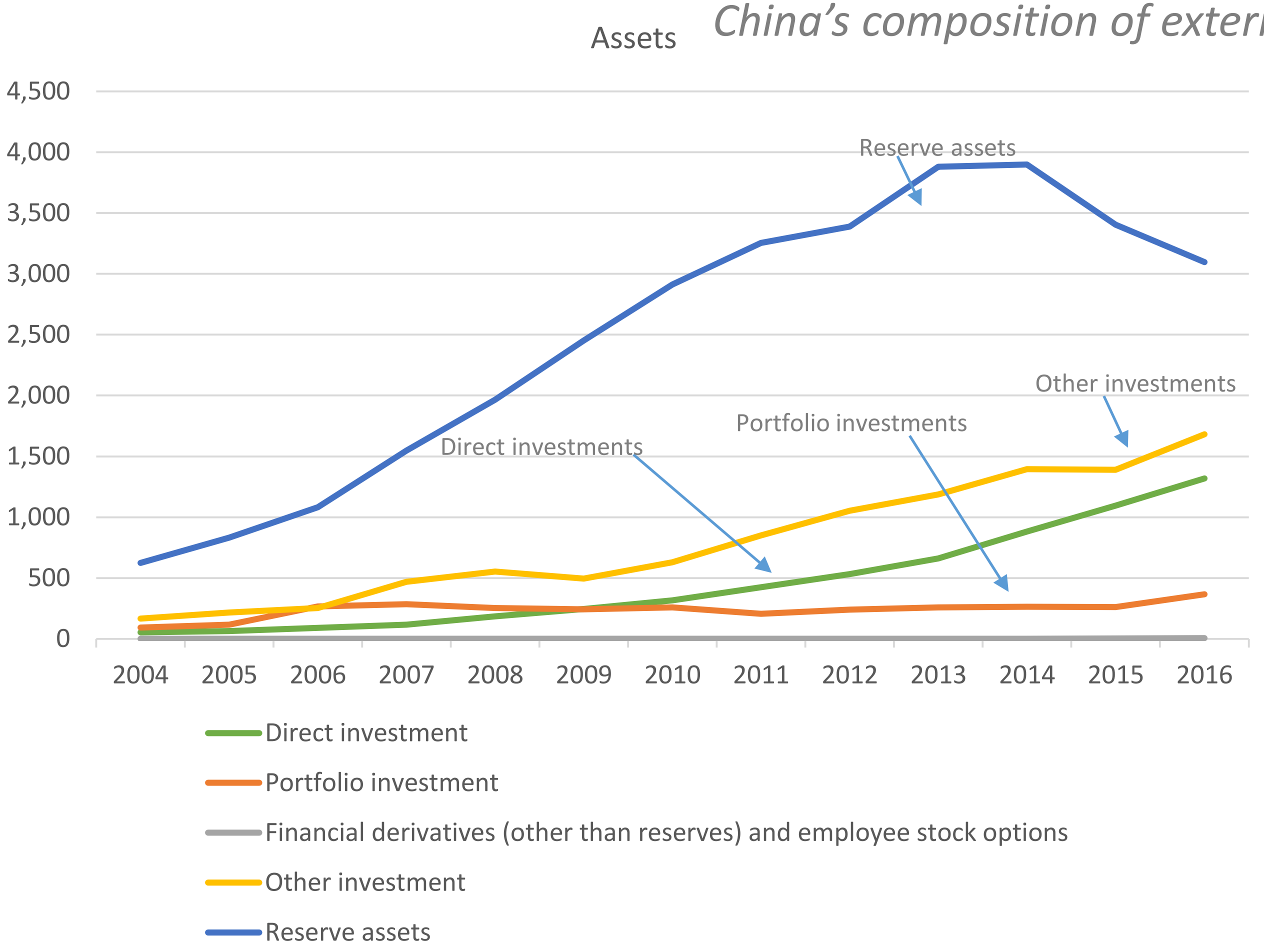
Source: OMFIF Global Public Investor 2017

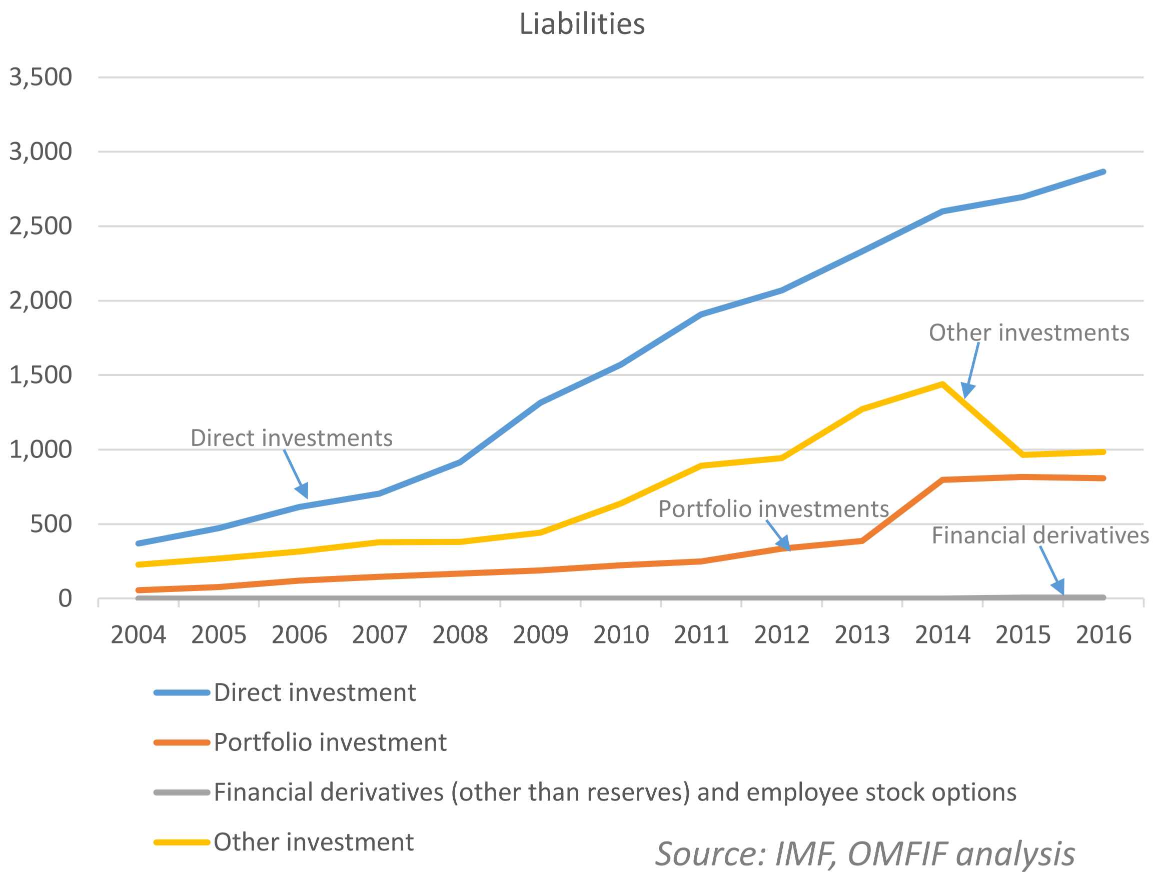
Changing nature of Chinese investment flows

- China is rebalancing its foreign investments away from holdings of other countries' debt (led by US dollar bonds) towards greater holdings of equity – with a large build-up in Europe over past 10 years
- Reflects effort to increase Beijing's return on foreign investments – imitating handling of overseas savings by Anglo-Saxon countries, led by US, UK (but including Canada, Australia, New Zealand)
- Borrowing in own currency on the domestic debt markets, and investing in foreign and domestic currency on international equity markets, can be a highly regarding strategy – as US and UK shows
- Earlier work (McCauley and Ma, BIS Working Papers, No 424, Global and euro imbalances), pointing out that China was overweight in its investment in dollar debt and underweight in non-dollar equity, may have had an effect in stimulating change
- Investment in German corporate assets appears to have continued at a high rate in 2016 in spite of capital controls aimed at cutting back on corporate takeovers outside Chinese companies' core areas. But investments appear to have slowed ion 2017 (perhaps also reflecting some German resistance) and 2016 may have e been the peak

China rebalancing: foreign direct investment replacing reserve assets

China's composition of external assets and liabilities, $bn



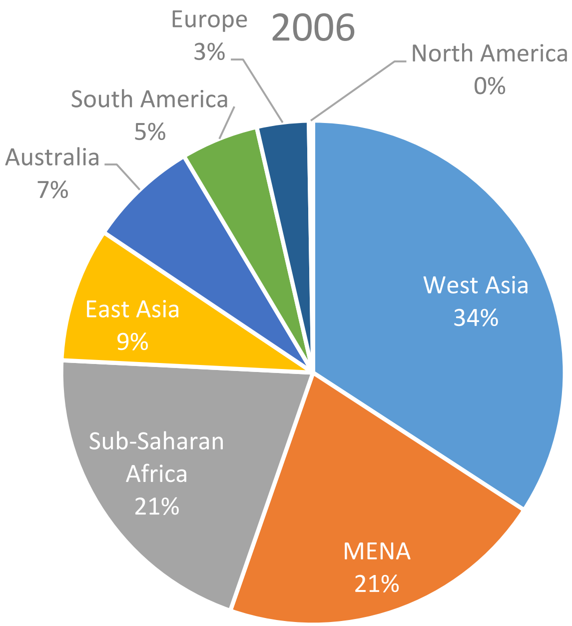


Source: IMF, OMFIF analysis

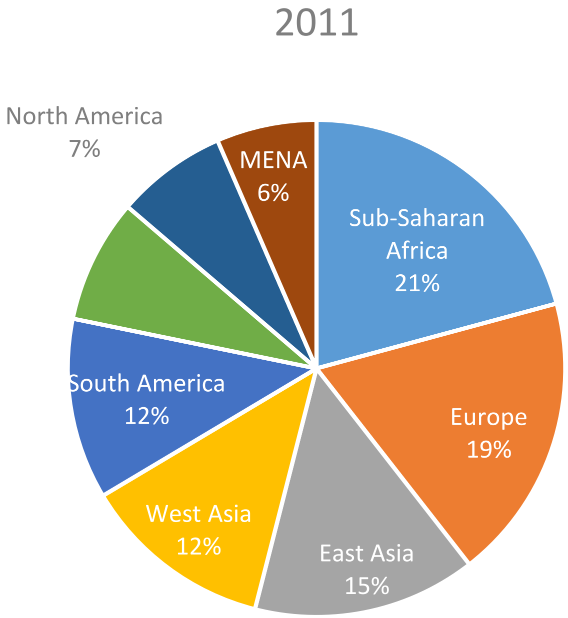
Foreign direct investment up % , reserve assets up % since 2004. Since 2014 rebalancing - reserve assets have fallen and FDI has continue to rise. This reflects dollar sales by the PBoC (partly to allow companies to repay dollar debt) – and moves to 'invest NIIP more wisely

Chinese investment trends

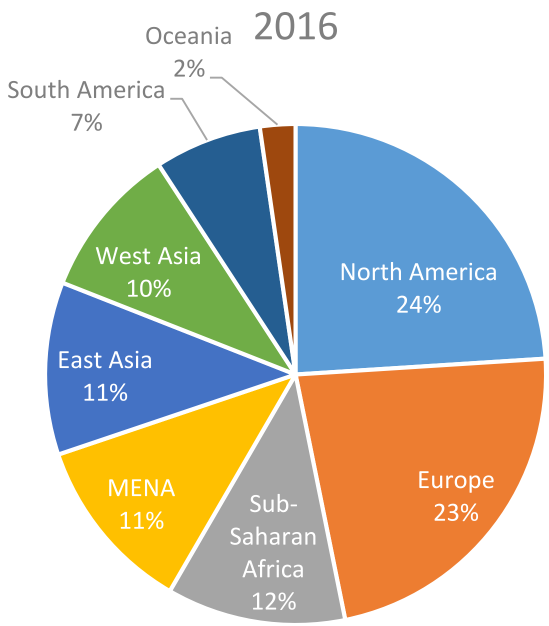
Big rise in European investment since 2006



Total: $41.5bn



Total: $124.2bn

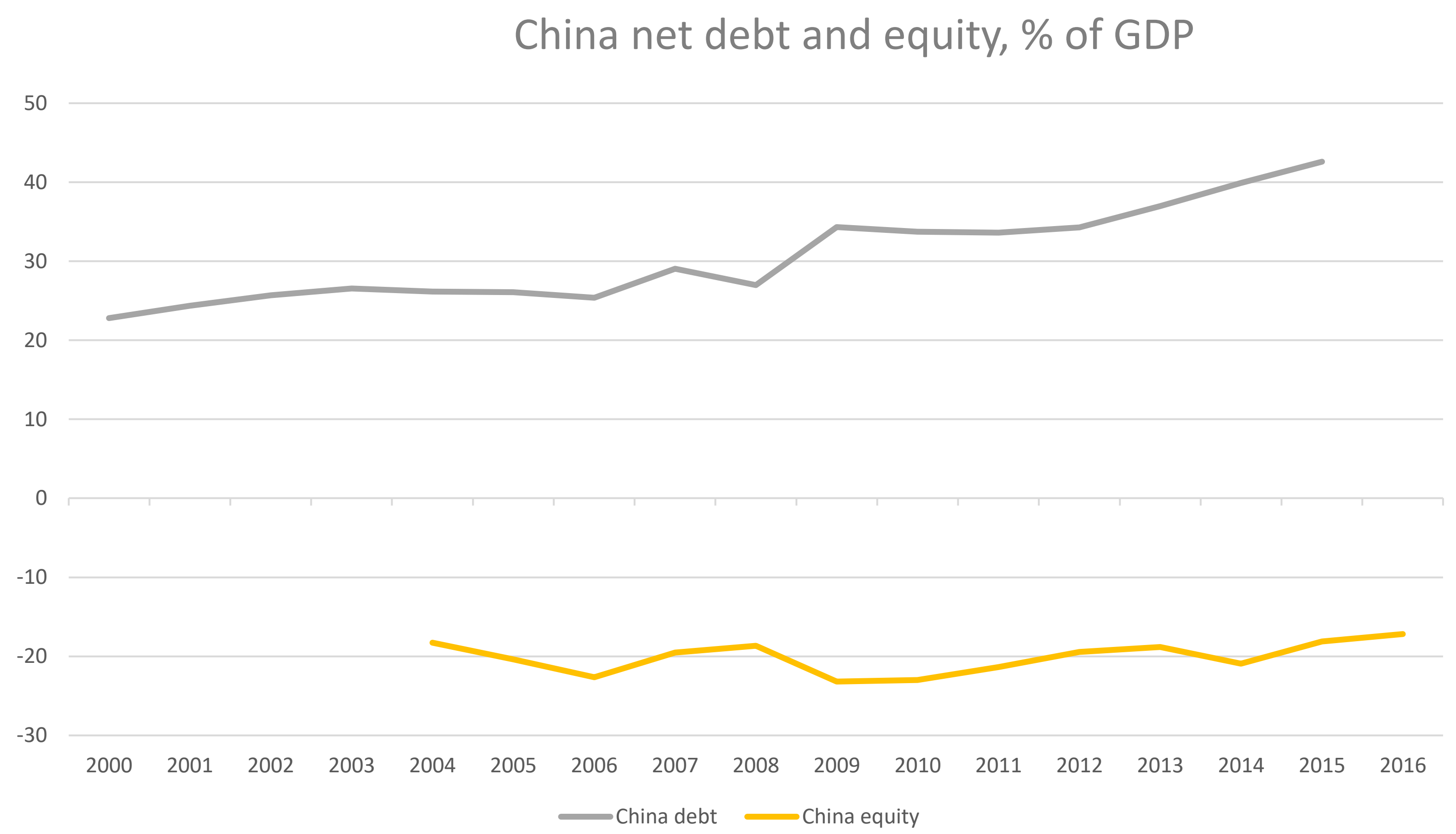


Total: $245.5bn

Source: American Enterprise Institute, China Global Investment Tracker, OMFIF analysis. Note: includes construction contracts.

The total annual value of global Chinese investments has increased by over $200bn since 2006. China has stepped up greatly investment in advanced economies. North America and Europe were the most important investment destinations in 2016 – insignificant in 2006.

China's net assets remain overweight debt, underweight equity

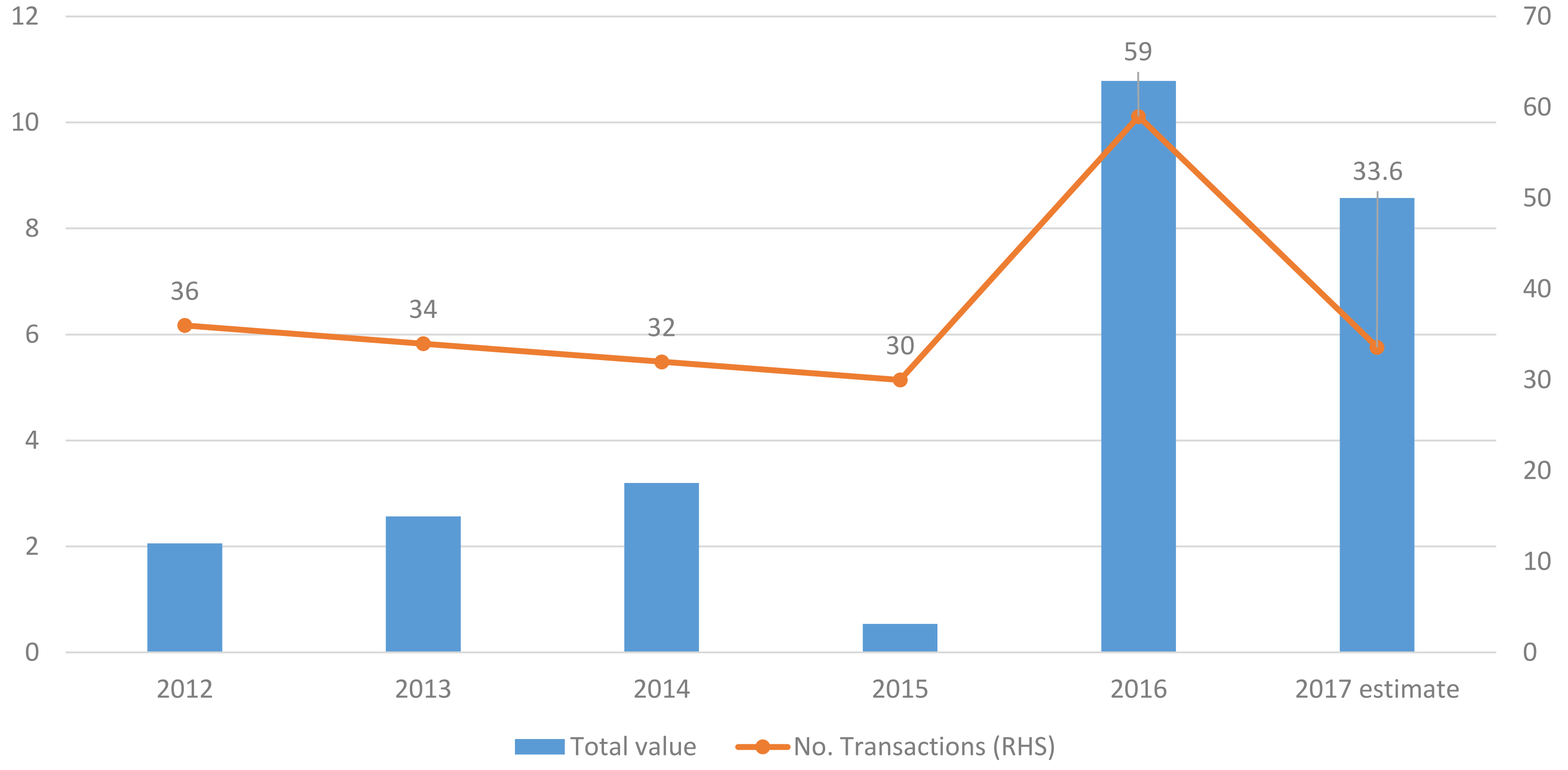


Source: IMF, OMFIF analysis

China's net assets are mainly in debt securities.

Chinese investor involvement in Germany peaks in 2016

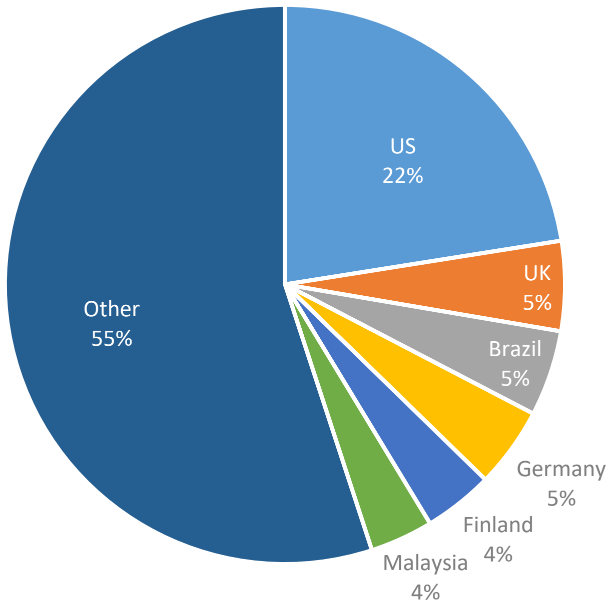
M&A involving Chinese participation in Germany per year, $bn



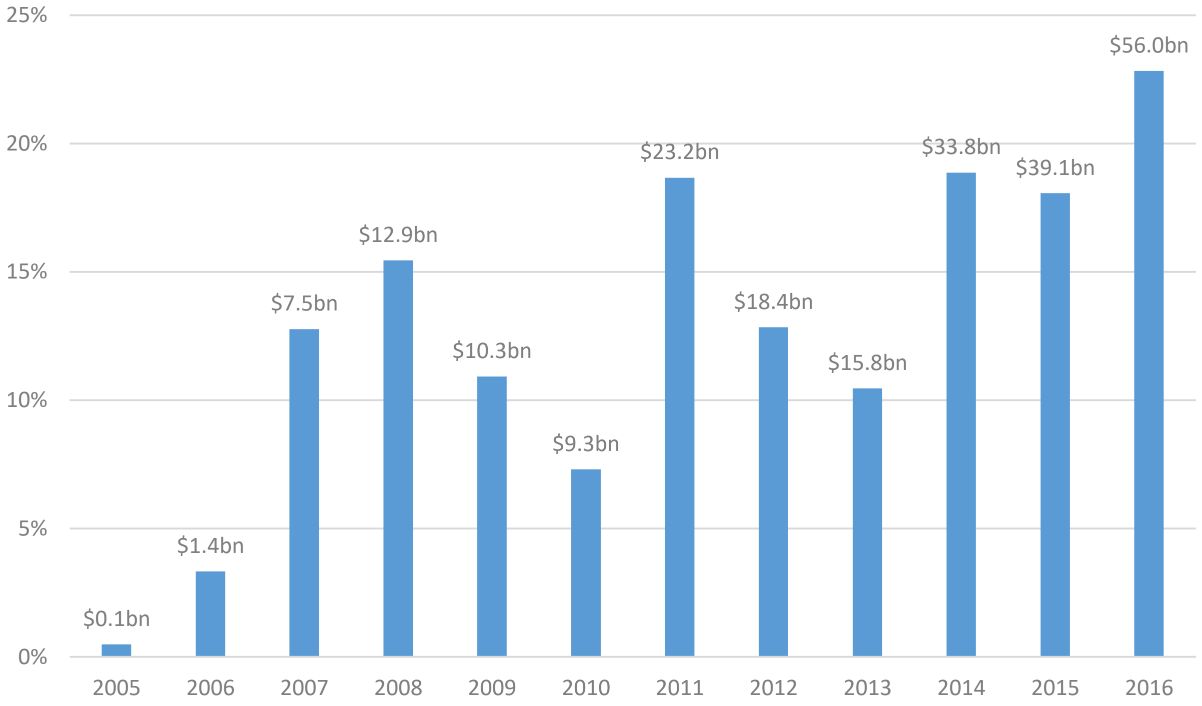
Source: Dealogic, OMFIF analysis

Chinese investments in 2016 mostly to the US followed by UK

Chinese investment, country breakdown, 2016



European share of Chinese global investment, %



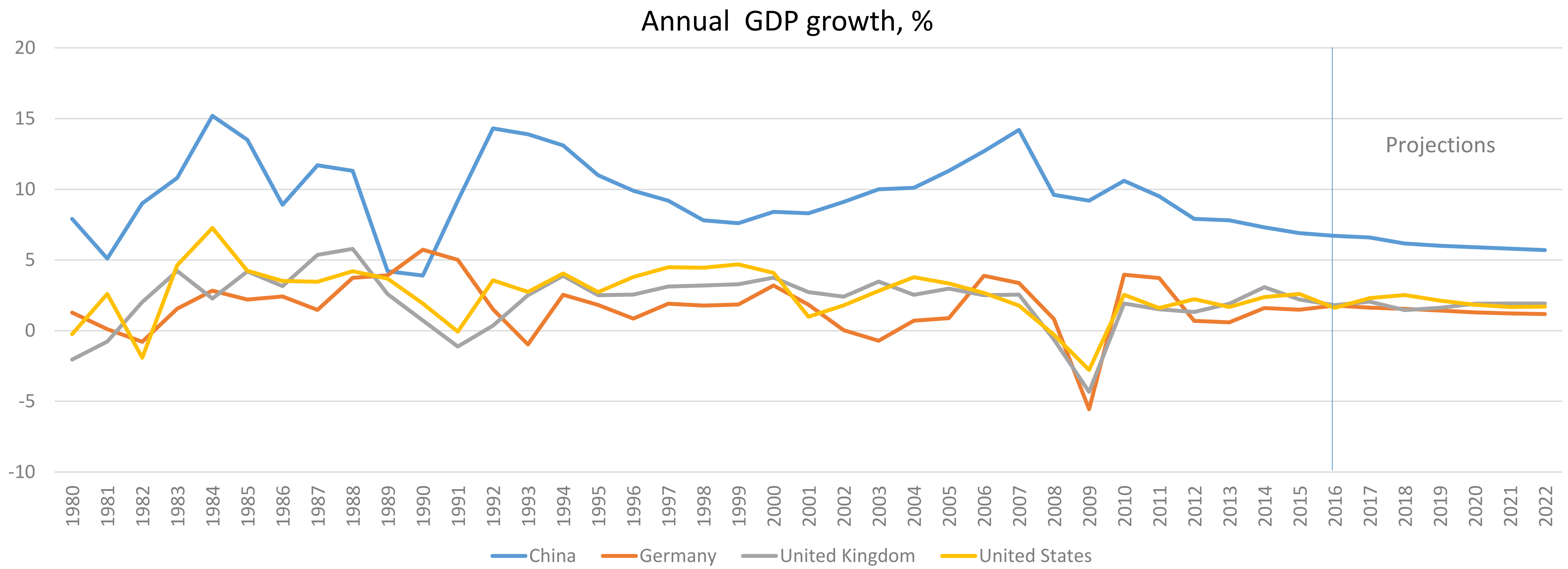
Source: American Enterprise Institute, China Global Investment Tracker, OMFIF analysis. Note: includes construction contracts.

Over a fifth of Chinese global investment flows to Europe, compared with less than 0.5% in 2005, however the US still dominates.

China's macroeconomic challenges

- Growth still at high level internationally – but slowing down
- China is suffering negative publicity – worries about possible debt crash, 2016 reimposition of capital controls, Moody's downgrade on 25 May (first time since 1989) reflecting high debt, lower growth and difficulties facing local government financing vehicles
- Negative response from Ministry of Finance ('Ratings company has underestimated the capability of the government to deepen reform and boost demand.')
- Fall-out from August 2015 mismanagement of exchange rate liberalisation still affecting renminbi sentiment
- China can make use of opening of offshore markets in renminbi to help improve its external asset-liability mix
- Growth of the Eurodollar market provides a case study of the opportunities for Chinese and non-Chinese enterprises' foreign financing capabilities
- China needs to take heed of historical parallels to avoid the pitfalls faced by various western countries in the past 50 years

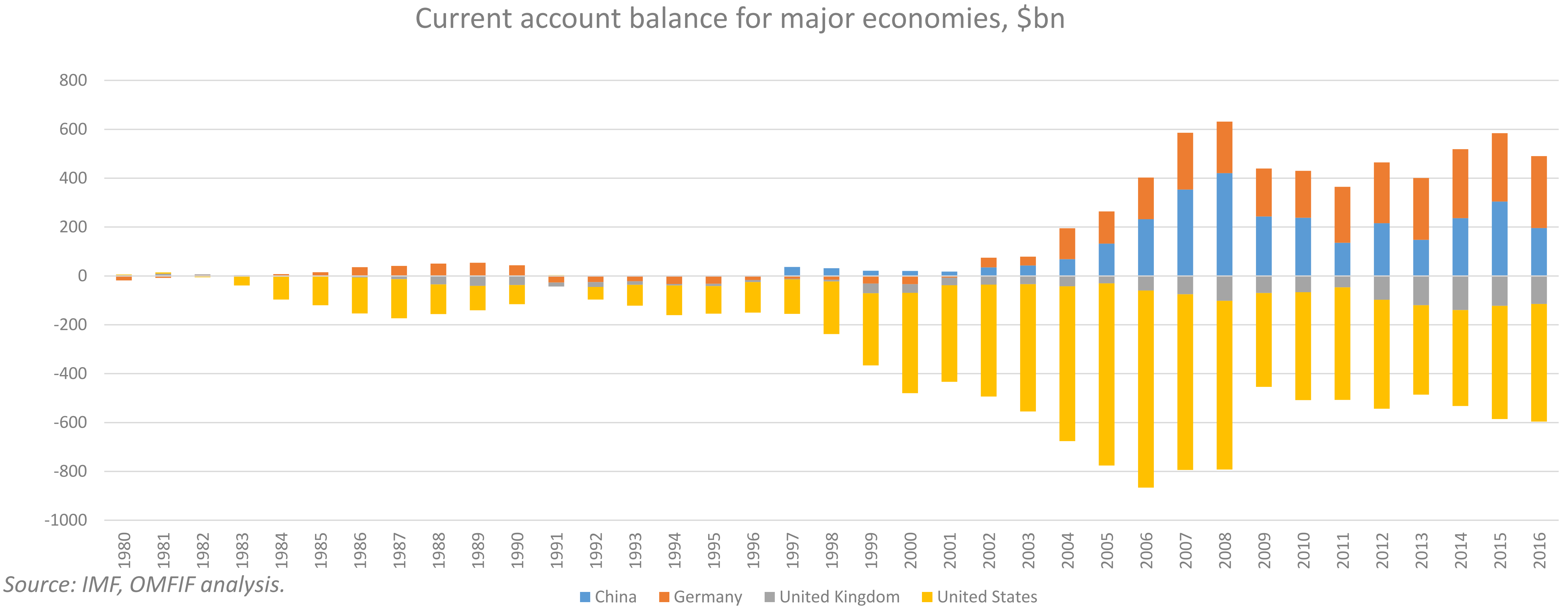
China's growth remains above other major economies



Source: IMF

China remains the world's foremost growth engine while Germany, US and UK fluctuate at lower growth levels. China rebalancing brings a flattening of the growth rate, but this is still 4 percentage points above other major economies.

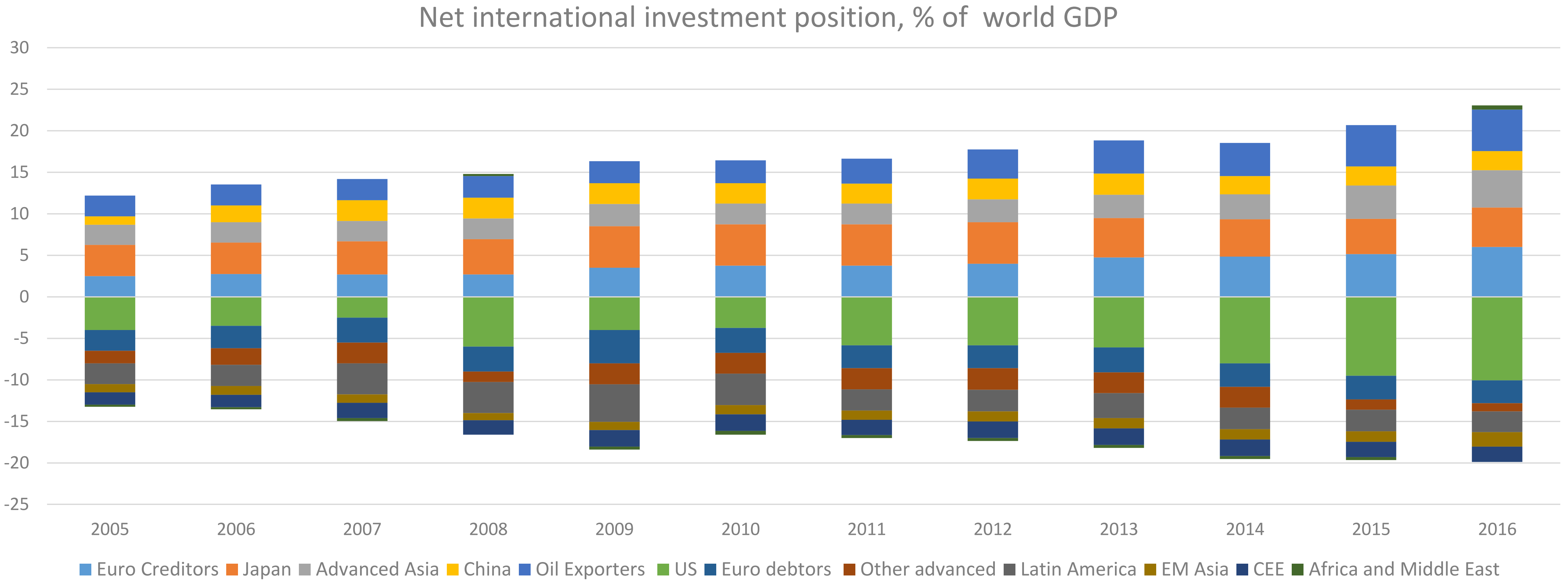
China current account surplus stabilises



Source: IMF, OMFIF analysis.

Chinese and German surpluses fund the widening US deficit and fuel China, Germany growing net foreign assets. US, UK current account deficits create funding need, including inflows from GPIs that buttress dollar, sterling as official assets

Debtor and creditor positions widen in 2016



Source: IMF, OMFIF analysis.

On the debtor side, the increase is explained entirely by rising net external liabilities in the US. In contrast, net external liabilities are projected to shrink further in euro area debtor countries. Among creditor countries, the increase in net external claims reflects the large current account surpluses in European creditor countries (such as Germany and the Netherlands) and in advanced Asian economies

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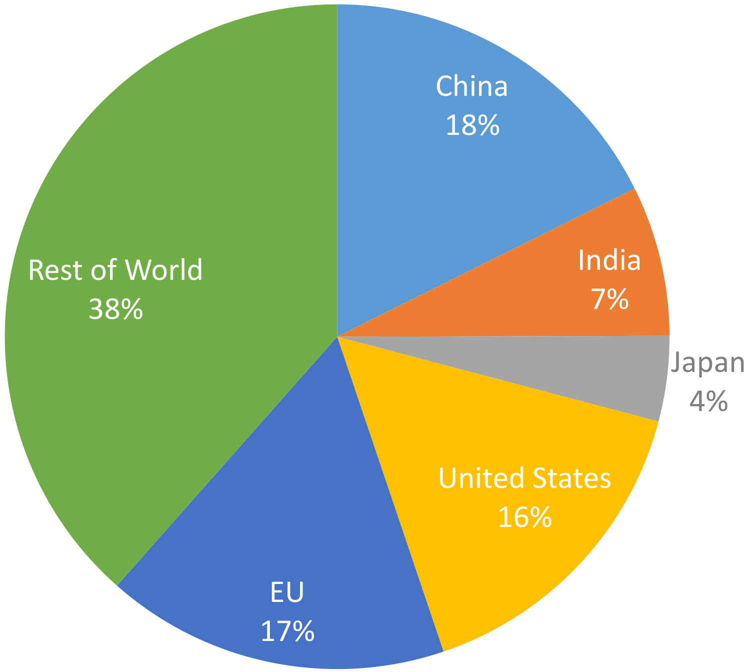
Renminbi reserve status

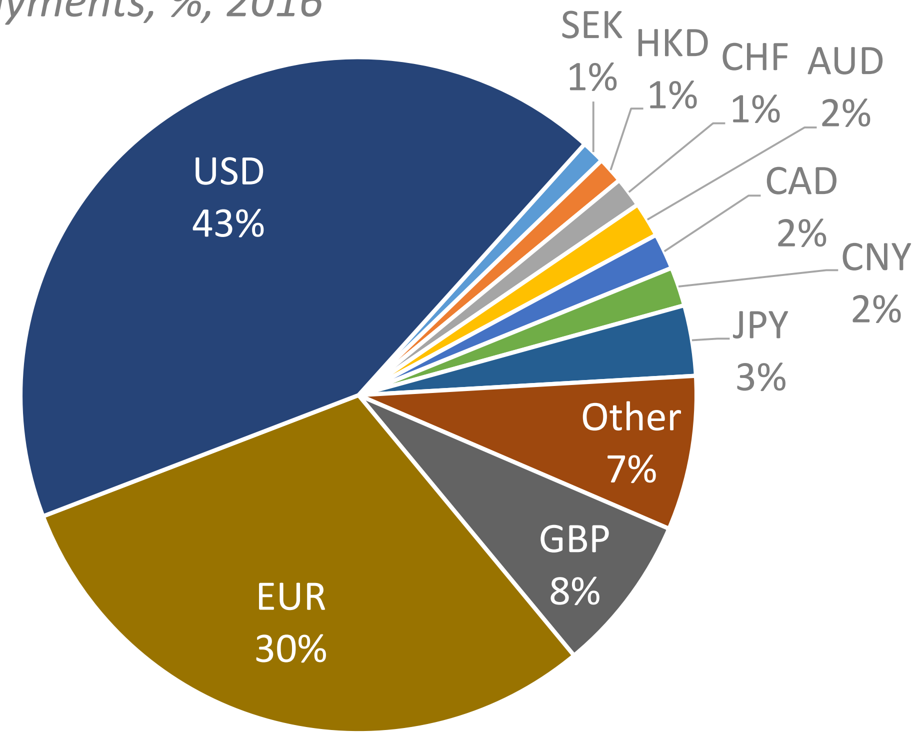
- At the end of March IMF reported holdings of $85bn of renminbi claims in the currency reserves of world central banks.
- Of eight currencies in the IMF's 'composition of official foreign exchange reserves', the renminbi is seventh most widely held.
- US reserve asset supremacy remains, with the dollar accounting for 64% of reported reserves
- The renminbi accounts for just over 1% of the $7.9tn disclosed in a total of 146 reporting central banks and other reserves-holding entities.

China a dominant global player but its currency lags behind

Share of world economy by GDP, %, 2016



Share of global payments, %, 2016



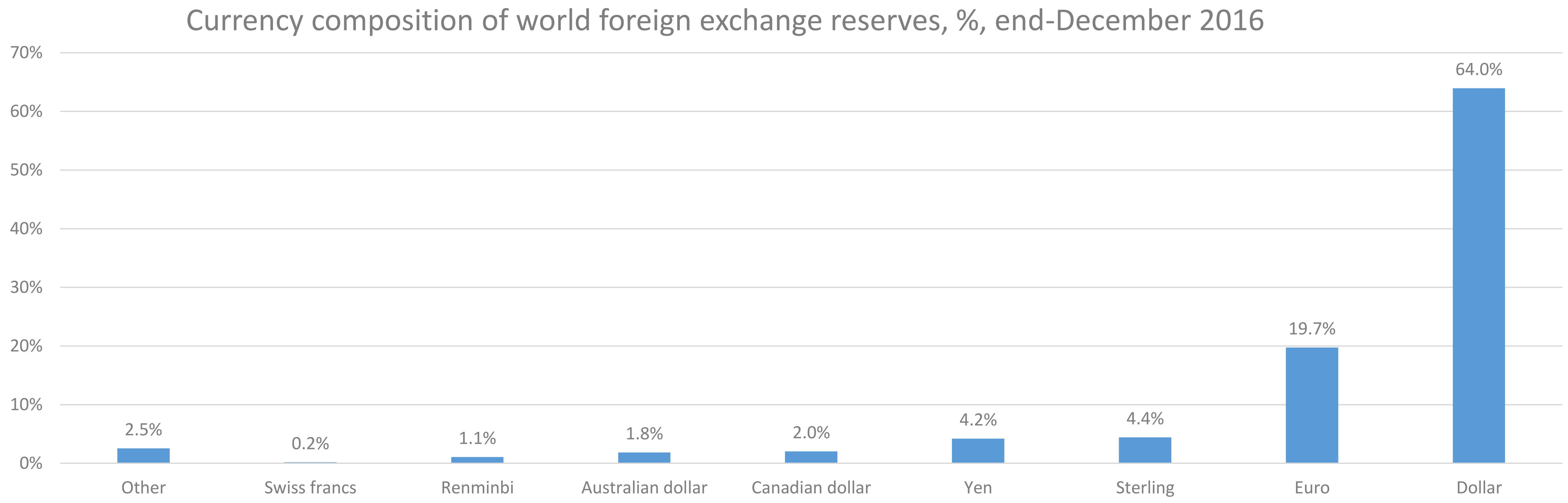
Source: SWIFT

China has advanced to become the world's second largest economy and the biggest trading nation with the largest foreign exchange reserves. The renminbi is unlikely to challenge the dollar and its pivotal position in world money for many years, but it may move up to become the No.3 currency and could even take over the euro's position over the next decade. Making the renminbi a workable currency for cross-border trade is a key part of Beijing's strategy for lowering dependence on the dollar and increasing self-sufficiency in economic and financial policy. In September 2016, the renminbi's share in global payments rose to the number five world payments currency

Renminbi below-weight on world scale

- Renminbi inclusion in SDR basket from October 2016 with weight of 11% (a third of the share of the euro and a quarter of the dollar's) - indicating that IMF expects renminbi's status to rise significantly
- Policy-makers must do more to allay concerns over currency manipulation, financial market transparency, and rising debt level
- Too few renminbi-denominated liquid assets for reserve managers to own.
- China's size implies reserve managers should hold around 20% of their liquidity in renminbi, implying that central banks should own a similar share of China's $9tn bond market.
- The use of the renminbi in global trade has diminished. In December, it accounted for 1.7% of payments, down from 2.3% a year earlier. In 2016, payments in renminbi fell by almost one-third
- $7tn equity market may provide additional depth, but central banks will continue to act cautiously
- In March the MSCI opted against wider inclusion of Chinese A shares in emerging market benchmark. In the long term, inclusion in the MSCI and FTSE could lead to $600bn in equity inflows

China reserves position disproportionate to economic clout



Source: IMF COFER, OMFIF analysis

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Task of renminbi-isation

- Renminbi-isation' will be a major theme for China in the next 10 years. China would be well advised to make the renminbi a major currency for commodity as well as trade financing
- The lesson from the US and Europe is that interest rate, capital flow and banking liberalisation needs to be carefully controlled and calibrated to attain maximum advantages for China
- Interest rate liberalisation will result in convergence of real interest rates between developed and developing countries.
- Chinese banks will lose income through higher rates on deposits but the drawbacks can be more than offset by higher fees from more sophisticated savings instruments and capital markets activities in China and abroad

Chinese liberalisation - benefits

- Facilitating a move for the renminbi to become, over time, the No. 2 reserve and market currency after the dollar will benefit Chinese economic flexibility and financial market prowess
- Capturing part of the dollar's 'exorbitant privilege'
- Driving modest international monetary reform through renminbi joining SDR adds to Beijing's international influence
- 'Renminbi-isation' of assets and liabilities can help reverse China's invidious position of recording a negative yield on its international investments - mirror image of US position (high returns on US direct investment abroad have helped keep US net investment income positive)
- Progressively extending freedom for Chinese investors - both public and private sector - to invest abroad will help generate positive returns from China's net foreign assets
- Allowing the renminbi to circulate with steadily greater freedom on foreign banking and financial markets will help Chinese banks and enterprises expand overseas
- Strengthening China's financial markets and banking, with measures to allow foreign investors access to onshore investments, will build up employment-generating financial activities

Chinese liberalisation - risks

- Loss of monetary control was reason for progressive weakening of the former Nationalist regime that led to the Communist takeover in 1949. Chinese authorities alive to risks crystallised in 1997-98 and 2008-09

- US policy-makers regularly opine that reserve currency status brings great responsibilities and burdens too - especially when this role is in decline or under threat, as witnessed by Britain in the 1960s and 1970s

- One of the many reasons for the formation of the euro was that the German government and Bundesbank were reluctant to see Germany take on undue risks through the D-Mark's growth as a reserve currency

Six lessons of liberalisation

1. Liberalising financial markets while keeping the capital account closed will provoke domestic asset price bubble as credit becomes more freely available but the opportunities for investment remain unchanged
2. Attempting a ‘big bang’ liberalisation, without having domestic institutions ready for the ensuing strains, will cause a crisis, as shown by Israel’s first failed attempt at capital account liberalisation in the 1970s
3. Capital account liberalisation can lead to large inflows and large outflows of capital. What matters is not the flows but how the authorities react to them
4. Countries need to balance domestic and international objectives and steer a midcourse between s competing priorities. A flexible exchange rate regime is essential to prevent domestic disequilibrium
5. Common experience is impossibility of predicting which way the exchange rate will move following capital account and exchange rate liberalisation. Sterling rose following removal of exchange control.
6. Liberalisation does not imply a completely laissez-faire approach : liberalisation in the US and Europe shows the importance of coordination and control. Capital controls may not be detrimental.