Rattus Sinicus

As the Year of the Rat[1] comes scuttling rapidly over the horizon, I thought it opportune to revisit developments in the PRC's capital markets, specifically trends in currency internationalisation, changing Chinese company listing imperatives, and proposals for issuing a sovereign, digital RMB. This also affords another opportunity to discuss developments in Hong Kong and to revisit my thesis that the SAR will probably be fine in the medium-term, if not for a significant swathe of the local Cantonese population.

The SAR will probably be fine in the medium-term, if not for a significant swathe of the local Cantonese population

Ordinarily, I would kick off the *gweilo* new year with an extended cyclical overview. However, since I set out my store only a few weeks ago during my "Regional Ramblings",[2] and because this piece is accompanied by my latest biannual chart anthology,[3] I will restrict my comments here to a brief recap of my take on the global, cyclical backdrop. Please skip to the specific China-Hong Kong section commencing on Page 8 should you feel so minded.

It remains supported by ongoing developments in the PRC's capital markets

As we enter a new decade, some of factors that have weighed heavily on Asia over the last year appear to be dissipating, or at least do not seem to be getting worse. The Fed is no longer contracting its balance sheet and broad money growth has begun to accelerate. Meanwhile, the People's Bank of China has also turned more accommodative albeit, unlike in the US, this has yet to deliver faster growth in the broader aggregates. Neither appear to wish to open fully the fire hoses but at least global liquidity conditions are no longer tightening.

As we enter a new decade, some of factors that have weighed heavily on Asia over the last year appear to be dissipating, or at least do not seem to be getting worse

---

[1] Methuselahean readers may recall (and forgive?) that I am recycling (Greta would approve) the Rattus title from twelve years ago marking the onset of the previous Chinese Zodiac circuit. Various stories are told why the rat is designated as the first animal in the cycle. One story tells how Emperor invited all of the animals in the kingdom to participate in a race across a river but only twelve (or thirteen) attended. The rat hitched a ride on the back of the ox, pushing the cat off on the way across (hence there is no year of the cat and the two have been sworn enemies ever since), and jumped off just as the ox (the second animal in the cycle) reached the shore. As an aside, the transition to the Rat marks the passing of the Pig which few, save perhaps Brick Top, https://www.youtube.com/watch?v=u3qy4Zv4snI will be mourning given China's *porcus annus horribilis*. Nemesis.

[2] November 14th 2019.

[3] Every six months, as much as anything to provide a comprehensive, quantitative check and balance on my often ill-founded, biased and subjective prognostications, I run the anthology of charts in the sister document attached. **DSG*Asia*** also runs tailored, proprietary macroeconomic databases for various clients. Get in touch should you wish to learn more.

Initial signs are also emerging that the global trade cycle may be stabilising while sentiment should be boosted, at least temporarily, by a time-out in the US-China trade war. Of course, tensions are about much more than just trade and will not be solved fundamentally by China agreeing to buy a few more American agricultural products. The recalibration of global supply chains is just beginning as is the Balkanisation of technology and financial markets.

Initial signs are also emerging that the global trade cycle may be stabilising while sentiment should be boosted, at least temporarily, by a time-out in the US-China trade war

The recalibration of global supply chains is just beginning as is the Balkanisation of technology and financial markets

The good news is that much of Asia is well positioned to benefit from such realignments assuming it can remain relatively politically neutral and can enhance its absorptive capacity. Not all production can or will relocate from China but even small shifts away from the PRC represent large numbers in the context of its smaller neighbours. A welcoming investment climate, flexible labour markets and improved infrastructure will all help to attract renewed FDI flows.

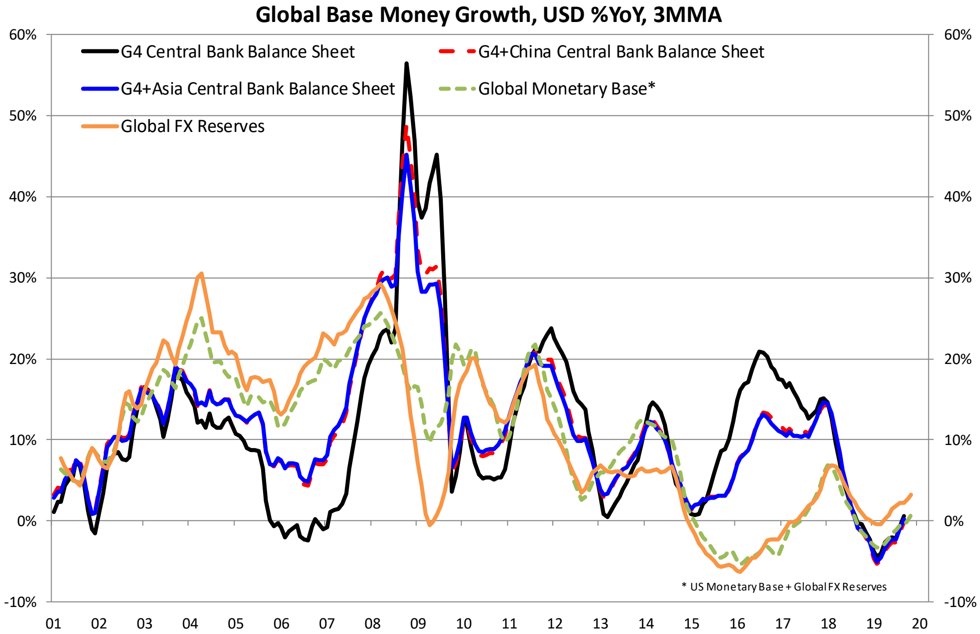
The risks to this relatively optimistic scenario remain largely external including: US political and market dislocations; renewed US-China trade tensions; and accelerating defaults in the PRC's highly stretched financial system. One cannot dismiss the potential for poor policy-making decisions and heightened local political tensions, but the region's domestic fundamentals remain largely sound with little evidence of major internal and external economic imbalances.

The region's domestic fundamentals remain largely sound with little evidence of major internal and external economic imbalances

Although a suspension of US-China trade hostilities will help underpin sentiment near-term, the change seen over the past half year in the stance of central bank liquidity provision – charted overleaf, principally a Fed phenomenon – is the fundamental underpinning in my belief in a *mild* economic upswing for the region over the course of 2020.[4]

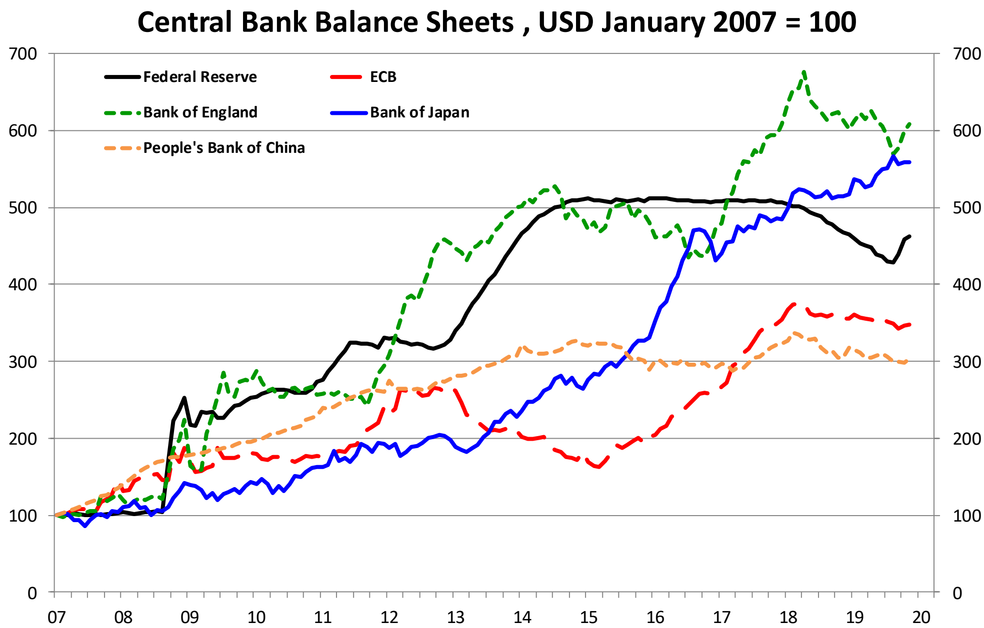
The risks to this relatively optimistic scenario remain largely external

[4] I remain an unreconstructed and unrepentant believer in the importance of financial balance sheets in economic analysis. This approach stems broadly from Milton Friedman's monetarist school and is founded on the belief that liquidity creation (and reduction) is the prime determinant of asset and goods price cycles. I fully accept that the demand for money is far from stable – especially in dynamic Asia – and hence I am reluctant to rely heavily on pure quantity theory to make spot inflation and growth forecasts. However, I firmly believe that excessive or insufficient money in an economy, allowing for some tolerance in demand for money (velocity) and lag variations, is the key medium-term driver of internal and external price trends.



Whichever way one wishes to measure it, aggregates of central bank parsimony/largesse have started to turn more accommodative in recent months. The decomposition below though shows this is almost exclusively a Fed phenomenon with only Perfidious Albion, these days a relative minnow, following suit.

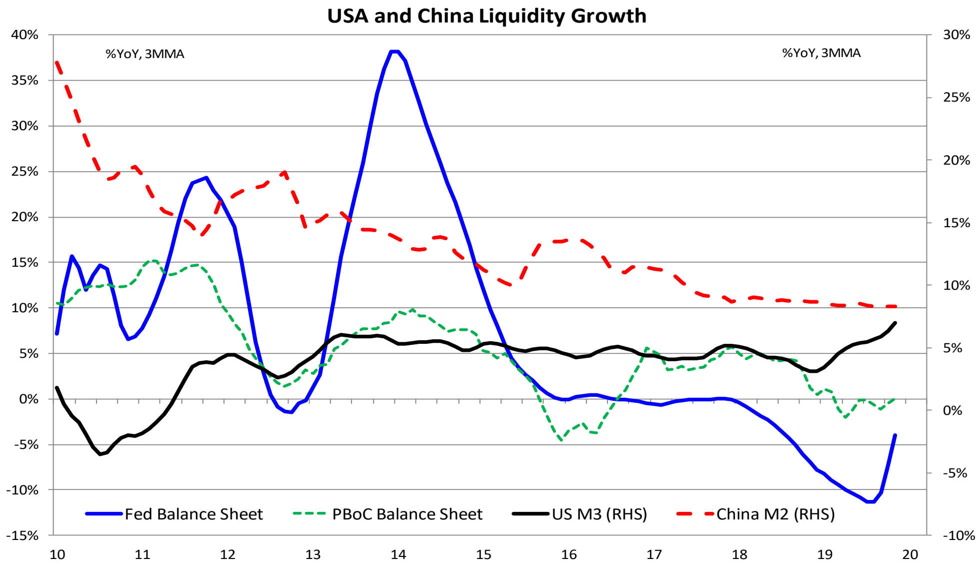
Aggregates of central bank parsimony/largesse have started to turn more accommodative in recent months



Rattus Sinicus

Central bank largesse, absent a pass-through transmission to broader money and credit growth, may be great for goosing asset prices near term, but does little if anything to boost nominal economic activity. In the post-GFC period, money multipliers have continued to sputter and it has been my long-held contention that central bank actions, their initial, albeit flawed actions to "save" the financial system excluded, have probably done more harm than good – both economically and politically.[5]

Central bank largesse, absent a pass-through transmission to broader money and credit growth, may be great for goosing asset prices near term, but does little if anything to boost nominal economic activity

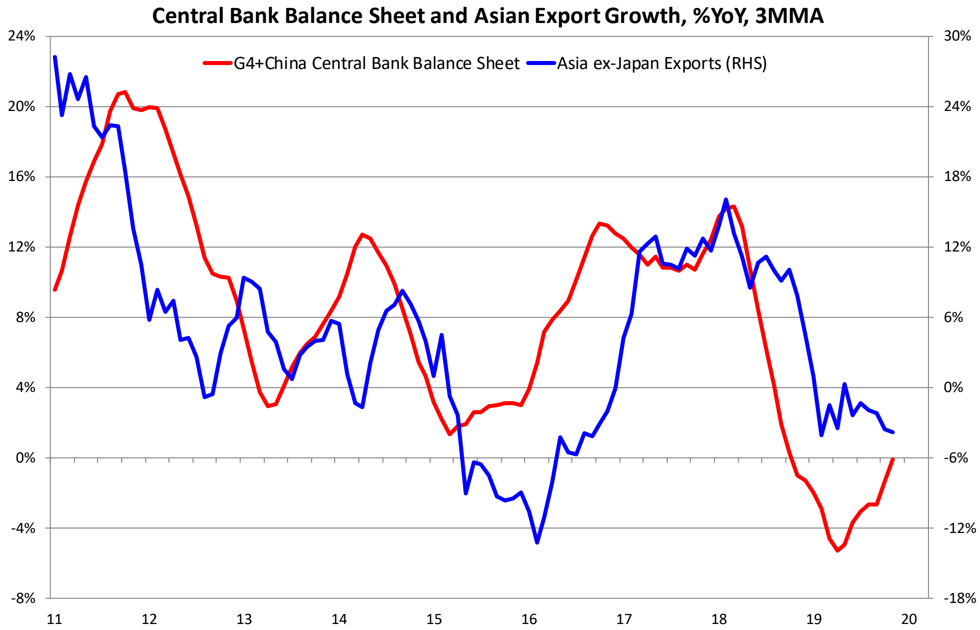


In the context of hitherto sputtering multipliers, it is notable that US broad money growth has broken out to the post-GFC upside in recent months. (Chinese M2 growth, which relies on rather different transmission mechanisms, has not budged; more on this later.) Of the major developed

It is notable that US broad money growth has broken out to the post-GFC upside

[5] The Bagehot-recommended response to flood the financial system with liquidity at times of major distress, when counterparty trust has been seriously eroded, is fully understandable and supportable. What modern central bankers appear to have forgotten is both Bagehot's "at a punitive rate" stipulation and his idea – mirrored in Keynes own writings on official interventions – that this should be a temporary expedient. By continuing to push their financial heroin of QE-infinity and zero-cum-negative interest rates, central banks have accommodated our descent into investment purgatory with more and more countries "Turning Japanese". In such a world, capital cannot be destroyed and zombie companies stalk the earth and poison the operating environment for the healthy. Potential growth grinds lower, business cycles become shallower and increasingly truncated, and one is reduced to trying to second guess both the timing of arbitrary political and central bank interventions and the vagaries of short-term inventory and production cycles.

economies, America had seen both the most resolute financial system clean-up post-2008 and the greatest recovery in entrepreneurial activity, albeit skewed towards a limited number of sectors. It was, therefore, arguably the major developed economy closest to full capacity which, politics aside, suggested that official rate-cutting and a *de facto* resumption of QE (whatever the Fed sought to dissemble) was hardly warranted. Should broad money continue to accelerate, it is an open question whether the growth pick-up that might be expected to follow with a lag would be of the nominal or real ilk. If the former transpires, then the reaction of bond markets could be torrid and the Fed could find itself having to reverse course pretty sharpishly.



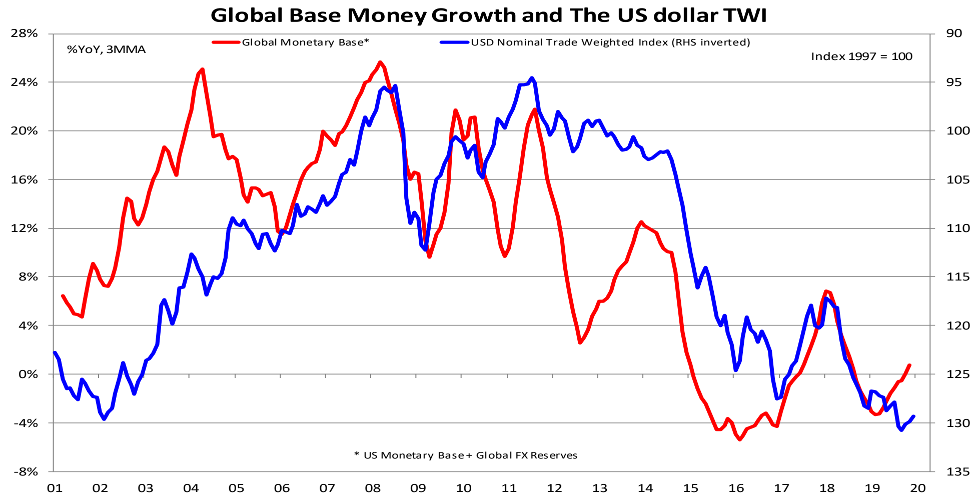
In my Footnote 5 rant I argued that in a world of QE-infinity and zero-cum-negative interest rates, potential growth grinds lower, business cycles become shallower and increasingly truncated, and one is reduced to trying to second guess both the timing of arbitrary political and central bank interventions and the vagaries of short-term inventory and production cycles. As the chart above suggests, my near-term optimism about a stabilisation and mild upturn in the all-important Asian export cycle is based on just this sort of vagary.

A stabilisation and mild upturn in the all-important Asian export cycle?

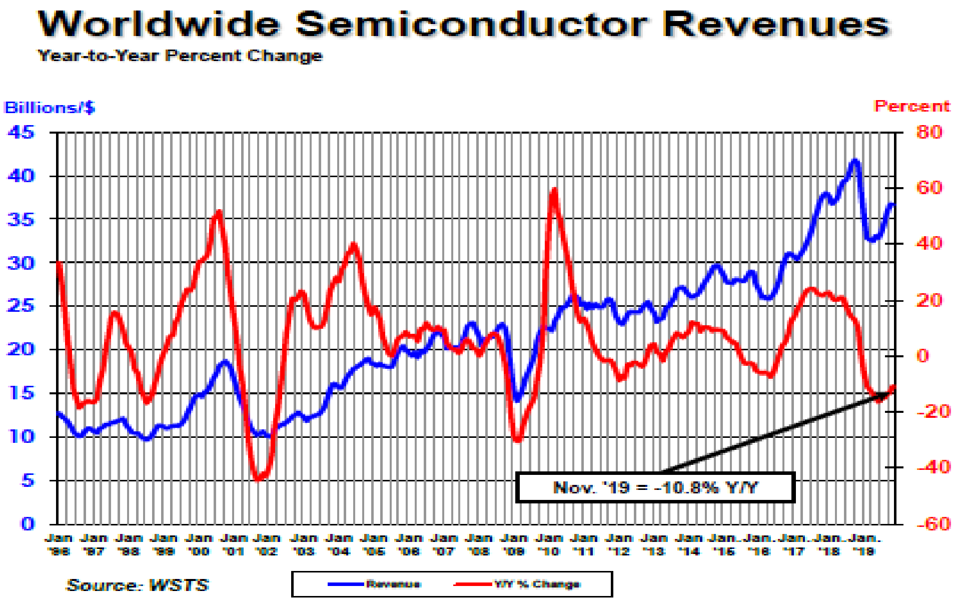
Rattus Sinicus

This may also deliver some *temporary* respite in the strength of the dollar. I firmly believe though it remains "three o'clock in the morning in the disco" when it comes to assessing against what the dollar can meaningfully fall; especially if the Fed is forced into yet another *volte-face*.

This may also deliver some *temporary* respite in the strength of the dollar



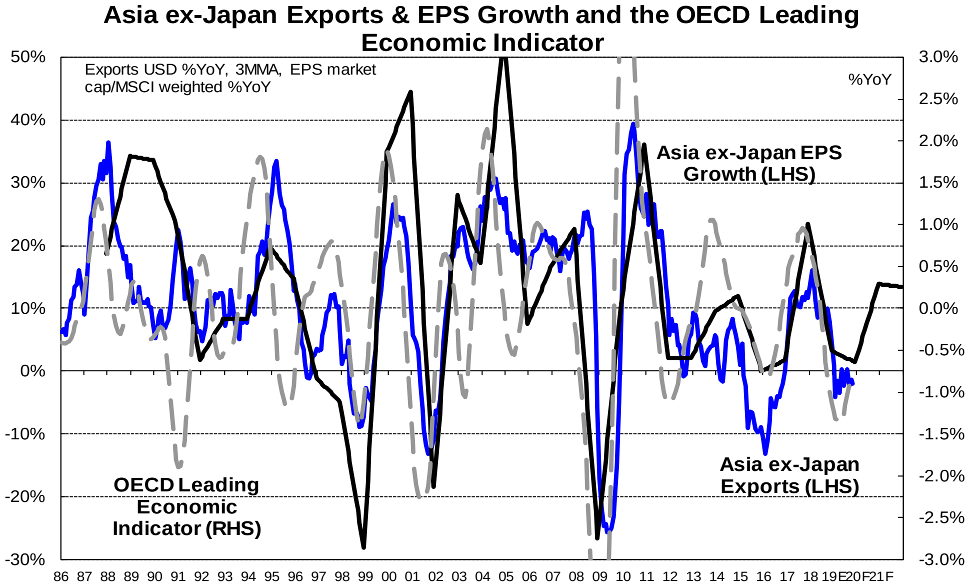
Asian export optimism can also be gleaned from recent semiconductor industry readings.[6]

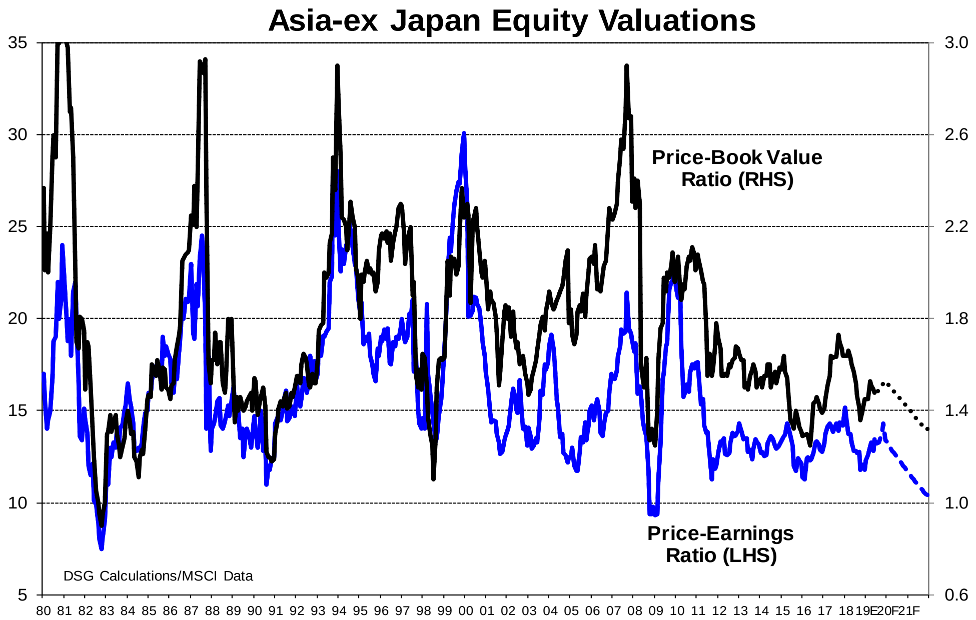


6 https://www.semiconductors.org/global-semiconductor-sales-decrease-slightly-month-to-month-in-november/

Nonetheless, whether all of the above can deliver anywhere near the corporate earnings recovery being forecast by bottom-up analysts is debatable. As the aggregate valuation chart below and the various individual county valuation charts included in the separate chart anthology collectively show, local equity markets are inexpensive, but not overwhelmingly so.

Whether all of the above can deliver anywhere near the corporate earnings recovery being forecast by bottom-up analysts is debatable



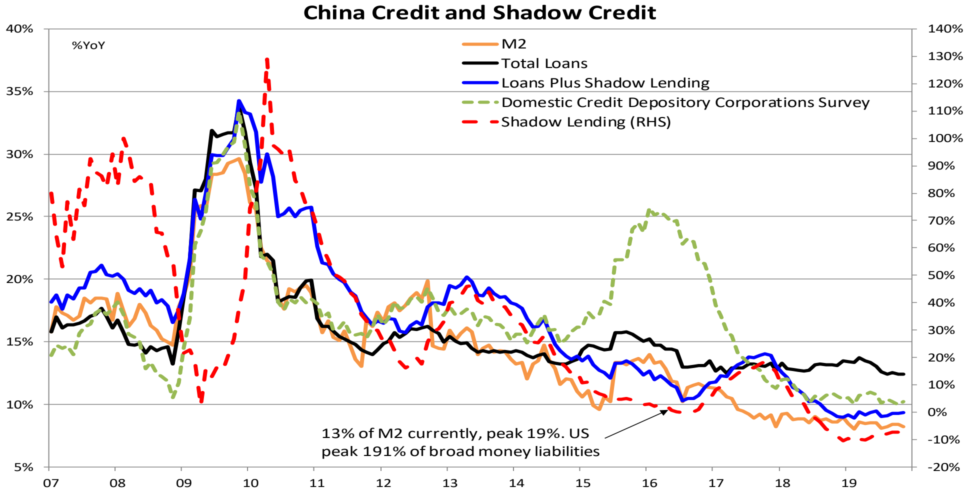


And, so to China. The PBoC's balance sheet is a very different animal compared to its Western counterparts. It has always been huge, peaking at two-thirds of GDP back in 2009 and even today, at around 40% of GDP, it is still twice as large as the Fed's.[7] Foreign assets comprise almost two-thirds of the total with the other third largely accounted for by various direct lending facilities.[8] The liability side, meanwhile, is broadly comprised of one-thirds cash, two-thirds bank reserves. The latter, in turn, is the counterpart to the massive sterilisation of central bank foreign exchange purchases at a time when China could justifiably be called an incorrigible currency manipulator. The required reserve ratio (for large depository institutions) peaked at around 21.5% towards the end of 2011 and has been reduced steadily since, largely to reverse sterilise, to today's 12.5%.

The PBoC's balance sheet is a very different animal compared to its Western counterparts

As the chart back on Page 4 suggests, changes in the PBoC's balance sheet have negligible impact on broad money growth. Rather credit supply (chart below), notwithstanding a series of technical tweaks in recent years to make interest rates more market determined, remains largely a function of quotas and regulatory fiat/forbearance.

Credit supply remains largely a function of quotas and regulatory fiat/forbearance

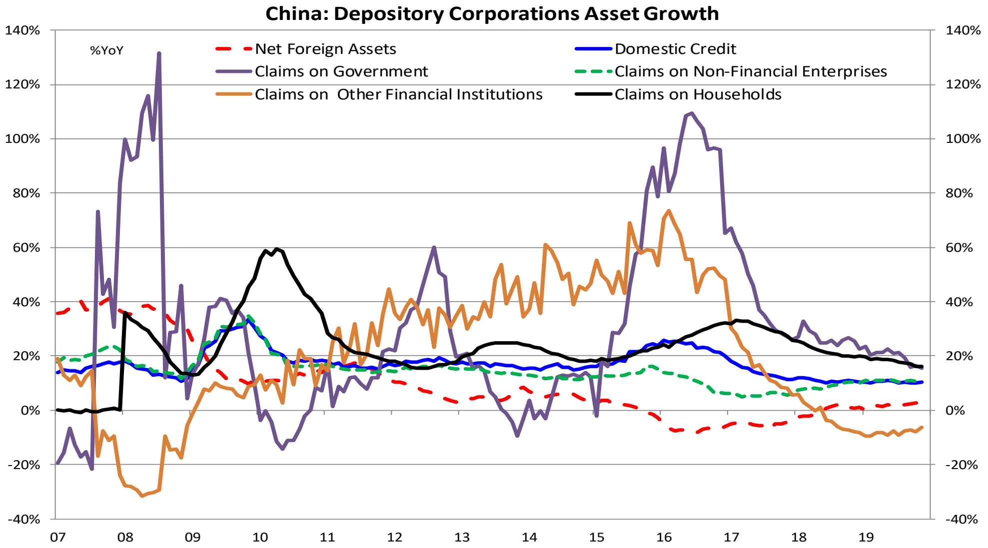


As the chart above shows, broad measures of credit growth have been steadily reined in and have been tracking sideways at around 10% YoY for the past

[7] The ECB balance sheet is around the same proportion of GDP as the PBoC's but all of them are dwarfed by the BoJ's 102%. Great success that has been….

[8] The Standing Lending Facility, the Medium-Term Lending Facility, the Targeted Medium-Term Lending Facility and the Pledged Supplementary Lending mechanism (definitely not a facility for the avoidance of doubt). Phew!

two years. Meanwhile M2 broad money supply is currently growing at its lowest rate since 1957! If we consider the counterparts to these decelerations (chart below) they have been concentrated in two areas: claims on other financial institutions associated with previously hyper-aggressive financial engineering between traditional and other non-bank/shadow lenders; and claims on the broadly defined government sector where many of the previous Local Government Financing Vehicle (LGFV) shenanigans took place.

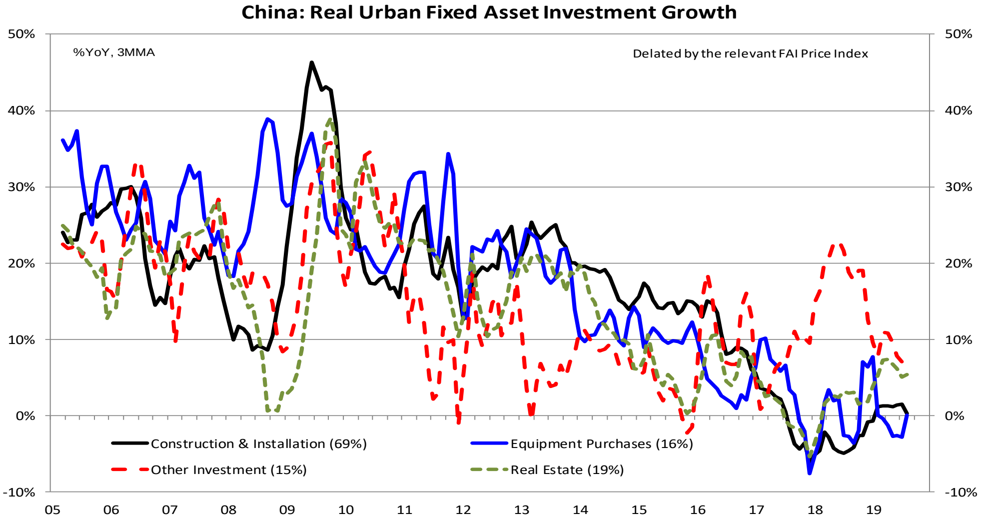


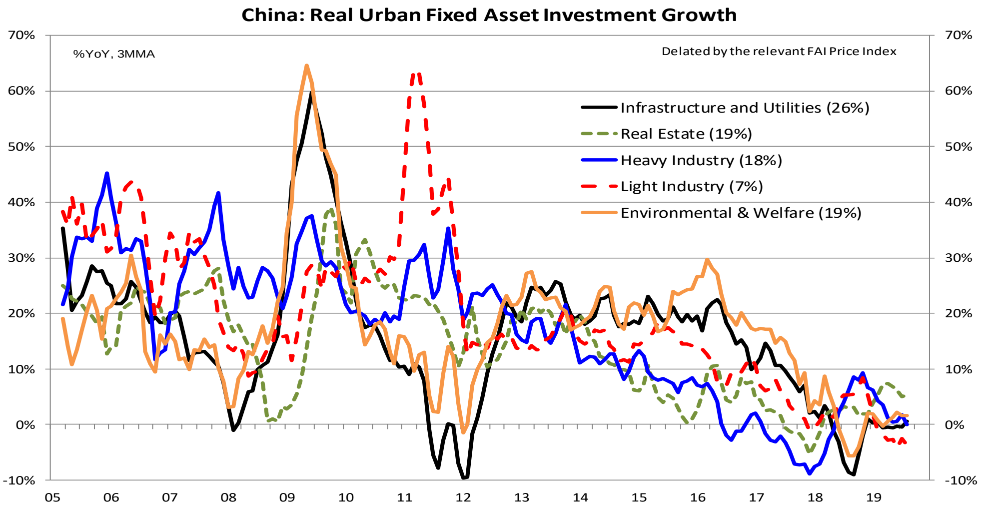
Intra-financial system lending continues to contract (as an aside, the shadow system has sprung back into life in America in recent times) which has hit the domestic private corporate sector hard. SMEs have been suffering particularly despite official exhortations/platitudes about encouraging greater bank lending to such parties. Meanwhile, other, larger borrowers have ventured offshore to tap alternative sources of funding complicating the task of exchange rate management. (I will return to the external accounts in due course.)

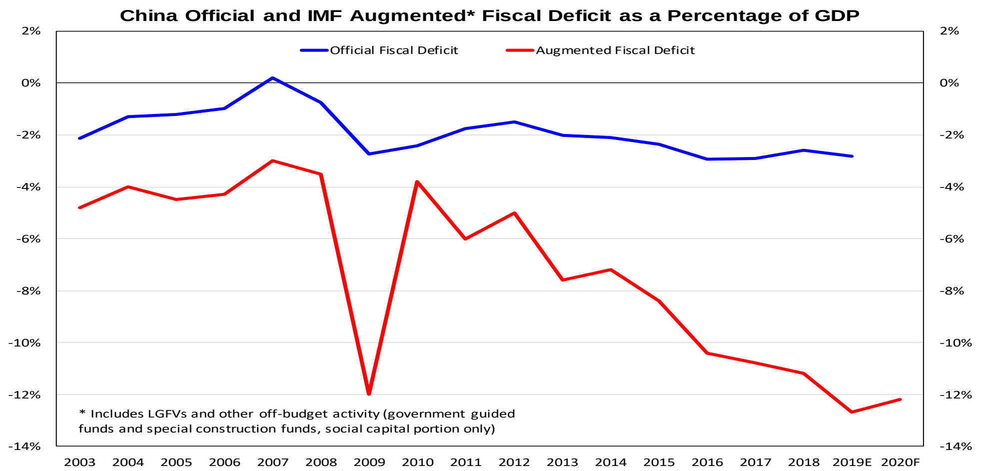
M2 broad money supply is currently growing at its lowest rate since 1957!

Unsurprisingly, the government sector is finding it rather easier to borrow although the fringes of the sprawling quasi-state are definitely being starved; understandable since the quasi-fiscal deficit already exceeds a tenth of GDP. This has complicated the authorities' efforts to employ fiscal policy to jumpstart fixed investment as per their normal playbook; a trend made even worse by the uncertainty created by ongoing trade tensions. Hayek may be given short shrift in Beijing but, in reality, the localities have had a far better recent record than the centre in getting stuff built quickly, even if sizeable leakages entail. The charts overleaf put greater flesh on these statements.

Unsurprisingly, the government sector is finding it rather easier to borrow than most

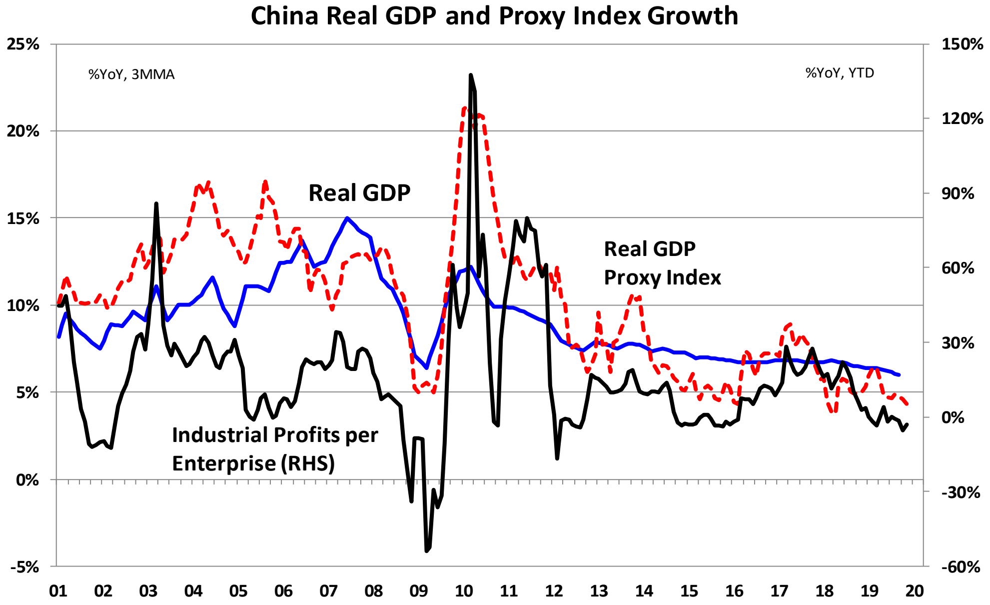

China: Real Urban Fixed Asset Investment Growth
%YoY, 3MMA
Delated by the relevant FAI Price Index
Construction & Installation (69%)
Equipment Purchases (16%)
Other Investment (15%)
Real Estate (19%)
50%
40%
30%
20%
10%
0%
-10%
05
06
07
08
09
10
11
12
13
14
15
16
17
18
19


China: Real Urban Fixed Asset Investment Growth
%YoY, 3MMA
Delated by the relevant FAI Price Index
Infrastructure and Utilities (26%)
Real Estate (19%)
Heavy Industry (18%)
Light Industry (7%)
Environmental & Welfare (19%)
70%
60%
50%
40%
30%
20%
10%
0%
-10%
05
06
07
08
09
10
11
12
13
14
15
16
17
18
19


China Official and IMF Augmented* Fiscal Deficit as a Percentage of GDP
Official Fiscal Deficit
Augmented Fiscal Deficit
* Includes LGFVs and other off-budget activity (government guided funds and special construction funds, social capital portion only)
2%
0%
-2%
-4%
-6%
-8%
-10%
-12%
-14%
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
2019E
2020F

The combination of tight money and credit advances, overstretched balance sheets, investment uncertainty stemming from both trade tensions/supply chain recalibrations, and Xi Jinping's desire to put the Party at the centre of virtually everything, continues to deliver growth below desired metrics, whatever the official numbers say. For what it is worth, my own estimates suggest a number nearer to 4% which is problematic given the authorities' promise to double per capita incomes from 2010 levels by the end of this year.

My own estimates suggest a GDP growth number nearer to 4%



Fortunately, the government recently concluded its latest economic census and found that 2018 nominal GDP was 2.1% higher than previously stated. Porcine-driven inflation, with added oil, may also perversely aid the cause. In any case, this is an economy that is sluggish rather than imploding, and if only statistical prestidigitation is required to deliver cherished income goals rather than an abandonment of newly found monetary discipline, this is no bad outcome.

This is an economy that is sluggish rather than imploding

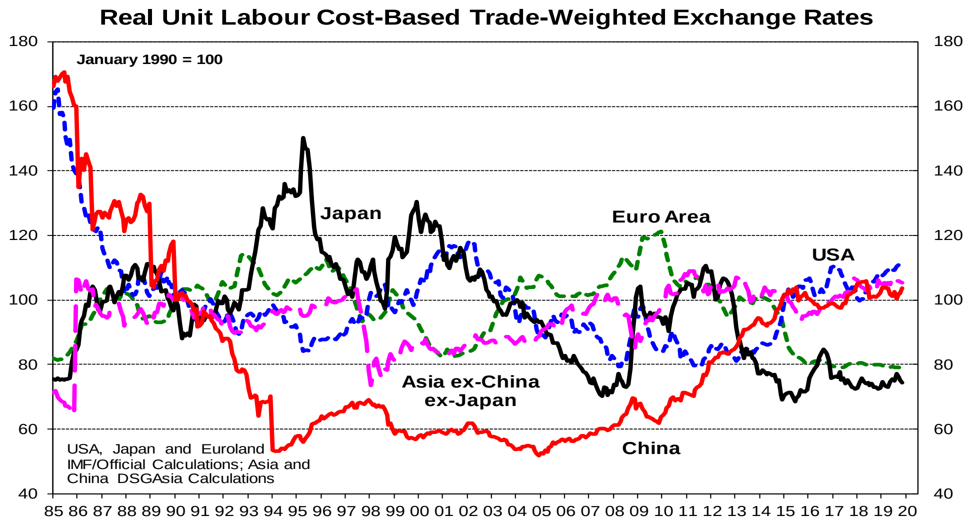
Aside from a desire to rein in debts that have reached Japan-1989 levels with only Japan-1970 levels of income,[9] the PRC has at least a couple of other good reasons to avoid another indiscriminate opening of the monetary taps: the security of the value of the currency; and the internationalisation of the currency.

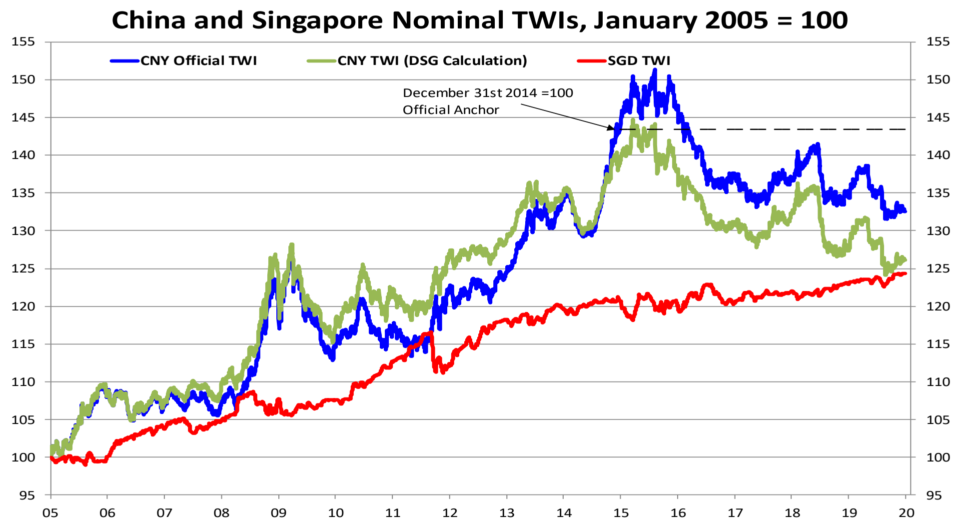
Consider now the security of the value of the currency; and the internationalisation of the currency

[9] As detailed in "China – Japan 1970 Development, Japan 1989 Debts", March 12th 2018.

Let us consider first the value and security of the RMB. I will not tarry on this section since I have regularly aired my views on the subject over the past couple of years and my thesis remains little changed. Whatever certain parties in the US would like to claim, the RMB is neither particularly undervalued these days nor is it being much manipulated, at least in a direction to prevent appreciation. Both in real and nominal trade-weighted terms it has been broadly stable over the past four years albeit this a concept that will likely test the comprehension of some in DC. The US dollar is undoubtedly strong, albeit for justifiable fundamental reasons, but it has been materially more overvalued in the past and hardly seems to be acting as a major brake on the US economy at these levels.

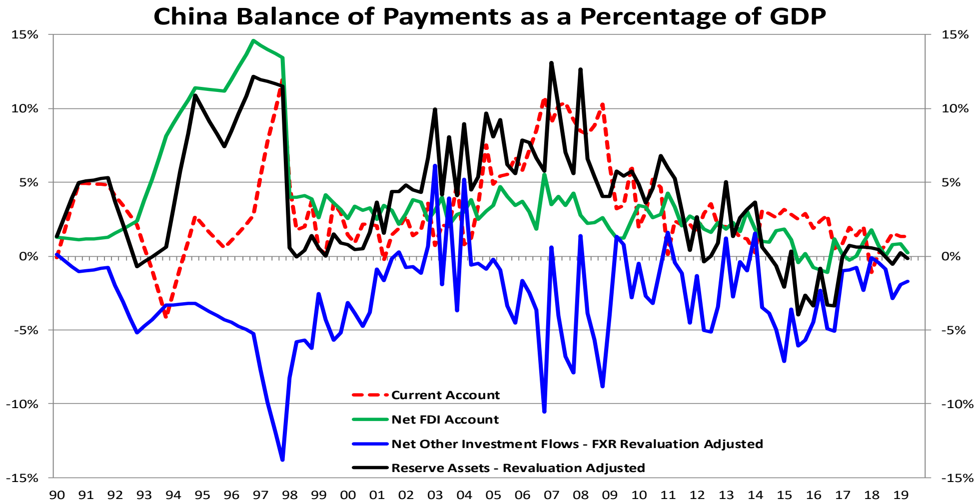
The RMB is neither particularly undervalued these days nor is it being much manipulated, at least in a direction to prevent appreciation





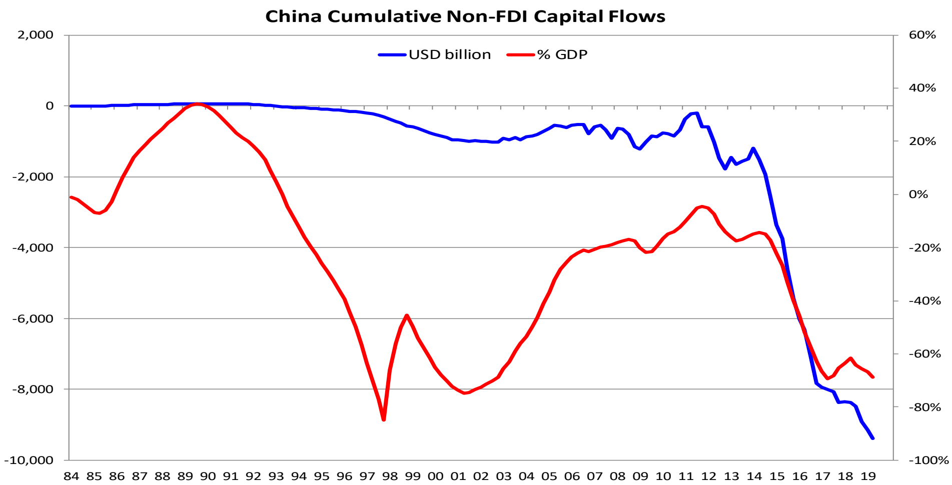
The more than doubling in the Chinese real exchange rate over the past decade has yielded a counterpart in a significant shrinkage in the PRC's hitherto massive current account surplus. Combine this with a substantially reduced net direct investment flows – a consequence of Chinese companies' increased desire to invest overseas rather than any material collapse in foreign inflows – and the robust basic balance is basically a wash these days.

The more than doubling in the Chinese real exchange rate over the past decade has yielded a counterpart in a significant shrinkage in the PRC's hitherto massive current account surplus



A more recent phenomenon has been the massive acceleration in non-FDI capital outflows. Based on the PRC's own international investment accounts, officially sanctioned financial outflows since 2015 have totalled around USD700 billion, implying a rather larger residual that seems harder to account for officially. Strangely enough, such outflows really kicked-off with the launch of Xi Jinping's anti-corruption drive.

A more recent phenomenon has been the massive acceleration in non-FDI capital outflows



China certainly has plenty of vocal nationalists these days. Whether the same are also patriots, defined as a love of one's country that is reflected in a willingness to keep one's capital (and children) at home, is perhaps a harder question to answer. Irrespective, the combination of a fully valued exchange rate, a basic balance bobbing around zero and a growing desire of domestic savers to diversify their financial capital away from the Motherland, implies that China is more dependent on the kindness of strangers than at any time since the early 1990s. Hence the internationalisation imperative.

Nationalism versus patriotism

Balance of payments pressures may have accelerated the pressure to attract foreign inflows into RMB-denominated assets, but this phenomenon also needs to be considered in the context of Chinese political economy. The idea that China is a seamless, perfect, centrally coordinated machine is a non-sequitur. In fact, currency and capital markets reform, like every other issue, is fiercely contested between different groups with very different personal perspectives and interests. Broadly speaking, I would posit that these fall into three camps: the nationalists; the technocrats; and the kleptocrats. Moreover, there are neither firm nor permanent borders between these different groupings.

Balance of payments pressures may have accelerated the pressure to attract foreign inflows into RMB-denominated assets, but this phenomenon also needs to be considered in the context of Chinese political economy

The nationalist camp seeks more immediately to escape and ultimately perhaps to replace American hegemony in (restricting the scope of our argument here) the monetary sphere. What is often lacking, certainly from domestic commentators but also from foreign cheerleading analysts who really should know better, is an understanding of what beyond raw power and huge volumes in trade is required to deliver a widely accepted, convertibly-traded currency. I will return to this subject when I consider the PRC's plans for a sovereign, digital RMB.

Currency and capital markets reform, like every other issue, is fiercely contested between different groups with very different personal perspectives and interests

China's camp of highly-educated and knowledgeable technocrats desire to use (a pacified?) Hong Kong, foreign security inflows and the offshore CNH market as Trojan horses to reform the Mainland's still-antediluvian local capital markets. In a number of areas their influence has waned under the re-centralising, statist drive of Xi Jinping, albeit far from entirely if the continued drive to rein in financial excesses discussed earlier is anything to go by.[10]

I would posit that these fall into three camps: the nationalists; the technocrats; and the kleptocrats

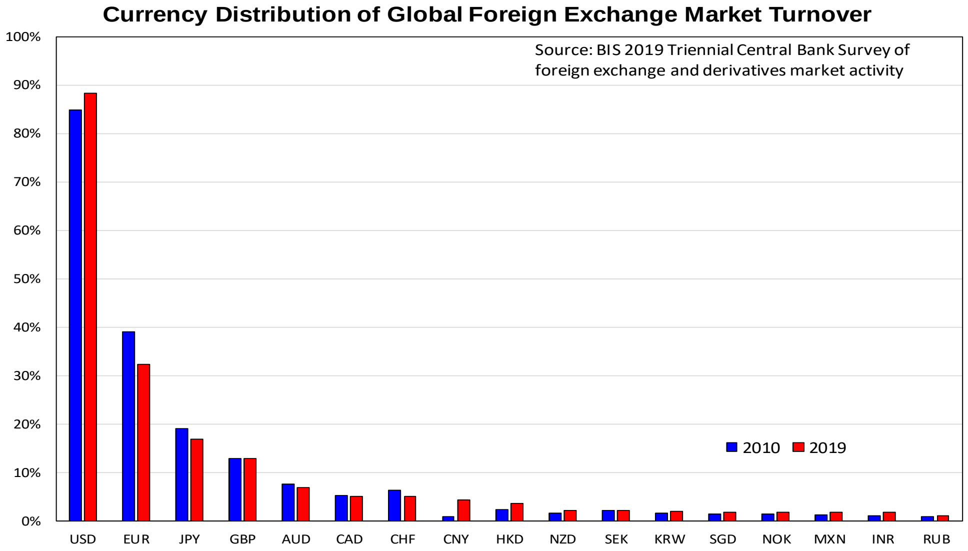
[10] Like many others, they have also become more reticent to express their views in the public sphere, especially with foreign interlocutors.

Finally, the kleptocrats, who may or may not also be nationalists and/or technocrats, seem to understand only too well, in the words of Li Shuhe and Li Shaomin in their seminal "The Economics of *Guanxi*" that *outsiders [may] perceive liberalisation as an opportunity to invest, while insiders see liberalisation as an opportunity to loot.*[11]

There are neither firm nor permanent borders between these different groupings

Over time I expect the RMB's role as a transactional, trade finance and internationally investible currency to be carefully and steadily expanded, though not without episodes of retrenchment. Yet I would stand by and, indeed, roll out almost indefinitely, my forecast of thirty years ago that full currency convertibility was at least thirty years away. The RMB as a secondary reserve currency on a par with say the Yen or the old Deutschmark? Very possibly. As a principal reserve currency that replaces or even operates at a similar level to the dollar. Unlikely in my lifetime.[12]

Over time I expect the RMB's role as a transactional, trade finance and internationally investible currency to be carefully and steadily expanded, though not without episodes of retrenchment



Notwithstanding the broad-brush statements above, what does the more recent evidence of RMB adoption or otherwise suggest? Turning first to the FX markets, as the chart above, sourced from the recently released BIS triennial survey on foreign exchange and derivatives turnover illustrates, the

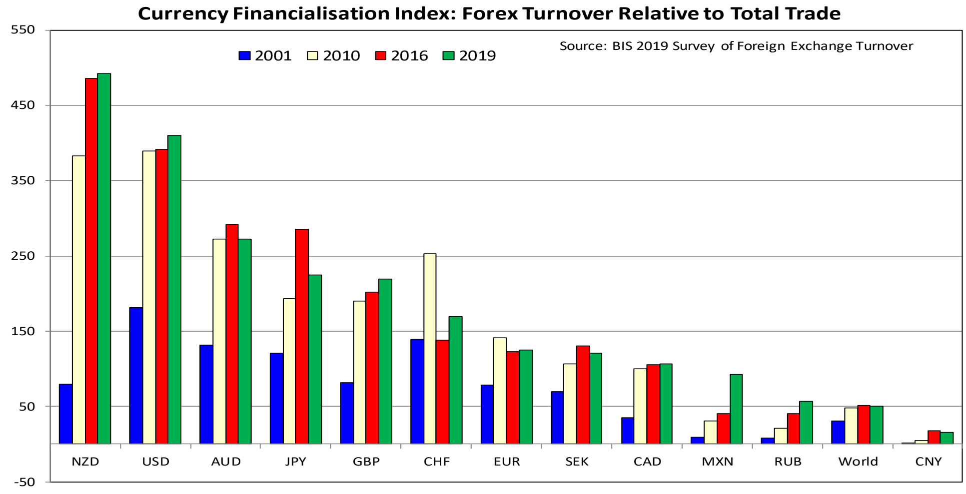
[11] China Economic Quarterly, Volume 4, Issue 1, 2000 Q1.

[12] The underlying assumption here is that fiat currencies as a general construct avoid complete collapse which, given some of the wilder monetary-fiscal experiments being mooted, is far from guaranteed.

RMB remains a pygmy in the rankings of international trade (and investment) currencies. Granted its share has increased from an extremely low base over the last decade and an optimist might seek to extrapolate. However, an erratic supervisory regime and an inconsistent commitment to maintaining an open trading market has, if anything, again increased counterparty cautiousness in recent years.

The financialisation chart below, which measures how much a currency is traded relative to its total cross border export and import trade, implies that aside from a minority of its physical trade, often with "friendly" counterparties, few players are willing or indeed able to deal in the offshore or onshore Yuan. A still meagre pool of internationally traded RMB assets and truncated currency hedging opportunities *outside of China* continues to stunt the internationalisation drive.

The RMB remains a pygmy in the rankings of international trade (and investment) currencies



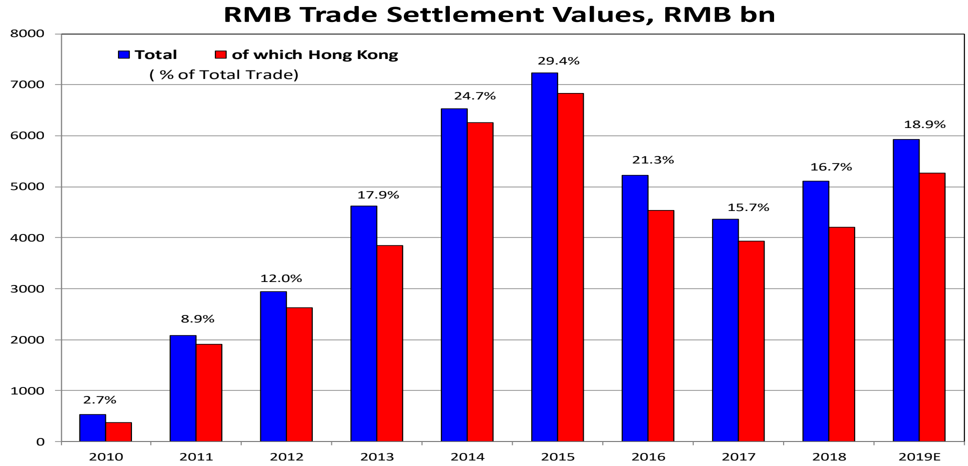
Like it or not, and many in Beijing certainly don't, Hong Kong remains indispensable at this juncture both as a controlled funnel for financial flows in and out of the Mainland, and also, say it softly, as the principal gateway for shovelling funds illicitly out of the country. If only the pesky, local ingrates could learn to love the Party and willingly accept their place in the celestial order, then all would be harmonious in the empire.[13]

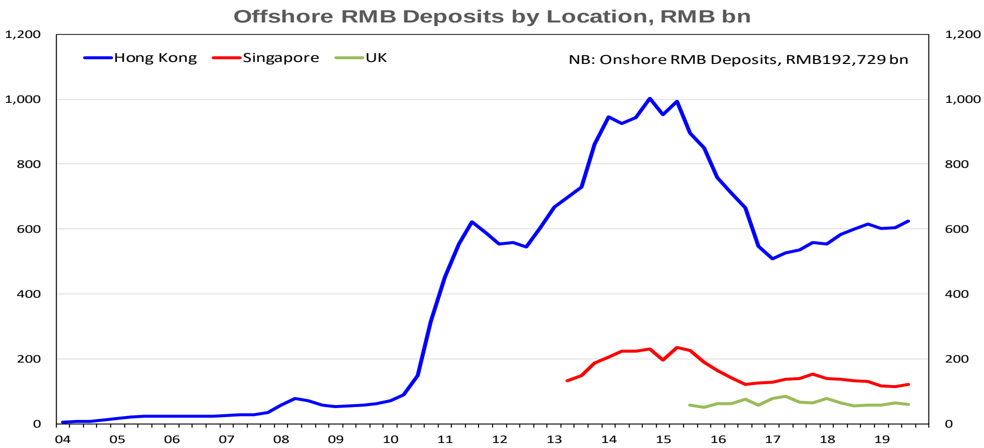
Like it or not, and many in Beijing certainly don't, Hong Kong remains indispensable at this juncture

[13] Failing that, some must be pondering Bertolt Brecht's "Solution": *[T]he people had forfeited the confidence of the government and could win it back only by redoubled efforts. Would it not be easier in that case for the government to dissolve the people and elect another?*

The SAR remains overwhelmingly the principal gateway for both RMB trade settlement and offshore RMB deposit taking (charts below). It also dominates bond and equity trading in and issuance for Mainland companies. Hong Kong combines an internationally top-notch financial and legal architecture with an un-replicable pool of talent with deep Chinese knowledge, connections and expertise. And, perhaps most importantly, it can be lent on whenever necessary to do Beijing's bidding should certain elements of free markets and international demand for transparency become inconvenient.[14]

The SAR remains overwhelmingly the principal gateway for both RMB trade settlement and offshore RMB deposit taking

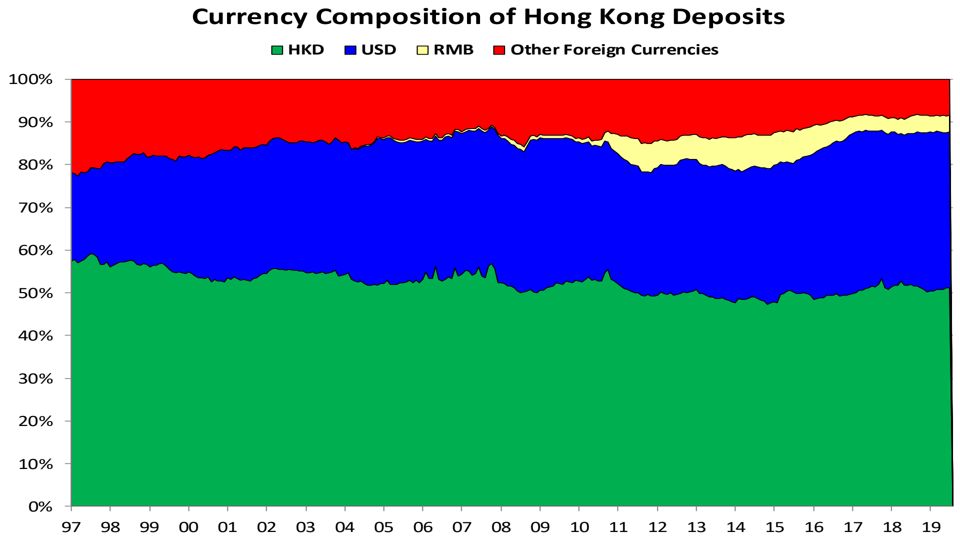




[14] There are analogies to be drawn here with the guff talked about business moving wholesale away from London to Frankfurt and Paris as a result of Brexit. Creating the architecture, culture and precedence for a world class international financial centre is no simple plug and play exercise. Jeremy Corbyn was a far greater risk but that particular bullet seems to have been dodged for now.

The willingness to hold RMB deposits offshore has to date been heavily driven by perceptions of where USD-CNY is going and as the bottom chart on the previous page and the one below show, the offshore RMB deposit pool has actually shrunk over the past half-decade. Meanwhile, local willingness to hold and use the HKD has barely budged. So, if you will permit me a brief digression, how might the proposed roll-out of the sovereign, digital Yuan affect these trends?

Hong Kong also dominates bond and equity trading in and issuance for Mainland companies



Anyone who visits the Mainland these days soon realises that paying for everyday goods and services in cash is becoming increasingly hard. The task is particularly taxing for the non-digital native elderly and also for the foreign visitor who does not come readily armed with all of the Chinese payment apps on his or her phone.[15] To the government's chagrin, these payment systems are currently controlled by "private" companies. Ones that will share whatever is demanded from the Party for sure but ones that are not fully controlled on a day-to-day basis. Hence the Party seeks to take back full monetary sovereignty control for the centre. I should flag, as I am sure you are more than aware, that I am no fintech expert. However, everything I have read about the putative design for the sovereign, digital Yuan suggests it will be built on a centralised as opposed to a distributed leger which would plug it into the ever-growing surveillance toolkit of China's digital panopticon.

What to make of the proposed roll-out of the sovereign, digital Yuan?

[15] Doing so comes with its own privacy and even personal security risks since phones are increasingly being searched at the border – less so for those without a Chinese face – for deviant and subversive content. Simon says: "take a burner!"

Beijing seems to be betting that increasing numbers will opt for convenience over privacy and begin to accept and use Chinese digital payments platforms.[16] At home, it looks like citizens will have no real choice otherwise. The prize though is to drive mass adoption of Mainland systems overseas while the West continues to be hampered by at least some checks and balances on acceptable behaviour. I suspect that Beijing will have considerable success in this area though that also it will contribute to an increasing Balkanisation of tech standards and spheres of influence. I am old enough to remember when the global traveller needed at least three different phones – one for the US, Europe and Japan respectively. We may be going back there, at least for those who want to be security conscious.

Beijing seems to be betting that increasing numbers will opt for convenience over privacy and begin to accept and use Chinese digital payments platforms

I should stress that widespread, overseas adoption of Chinese payments systems only applies, at this stage, to current transactions which remain merely a tiny subset of total investment flows. The broader challenge for Beijing remains to create a large enough pool of investible RMB assets and hence sufficient trade and investment flows in its own currency to be able to bypass the US-dominated financial system.

The broader challenge for Beijing remains to create a large enough pool of investible RMB assets

International investor purchases of onshore Chinese assets are, from a very low base, on the rise (see charts overleaf), especially in the sovereign bond markets thanks to the RMB's inclusion in the SDR basket, and increasingly on the local bourses, almost all of which is funnelled through Hong Kong. Nevertheless, many remain leery about Mainland accountancy, legal and convertibility issues and continue to prefer to invest in offshore securities where they perceive their investment protections are somewhat more robust.

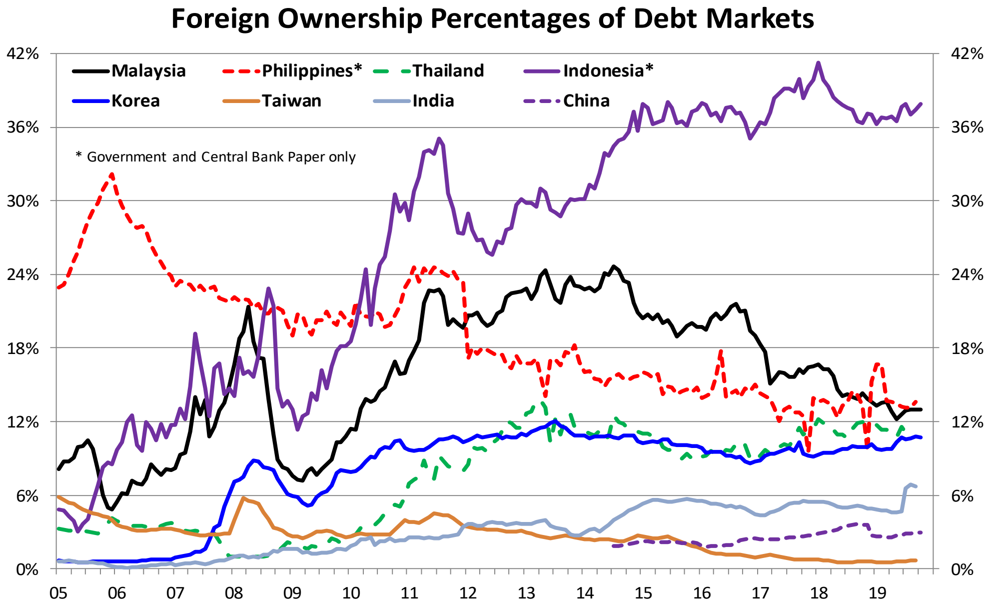
International investor purchases of onshore Chinese assets are, from a very low base, on the rise

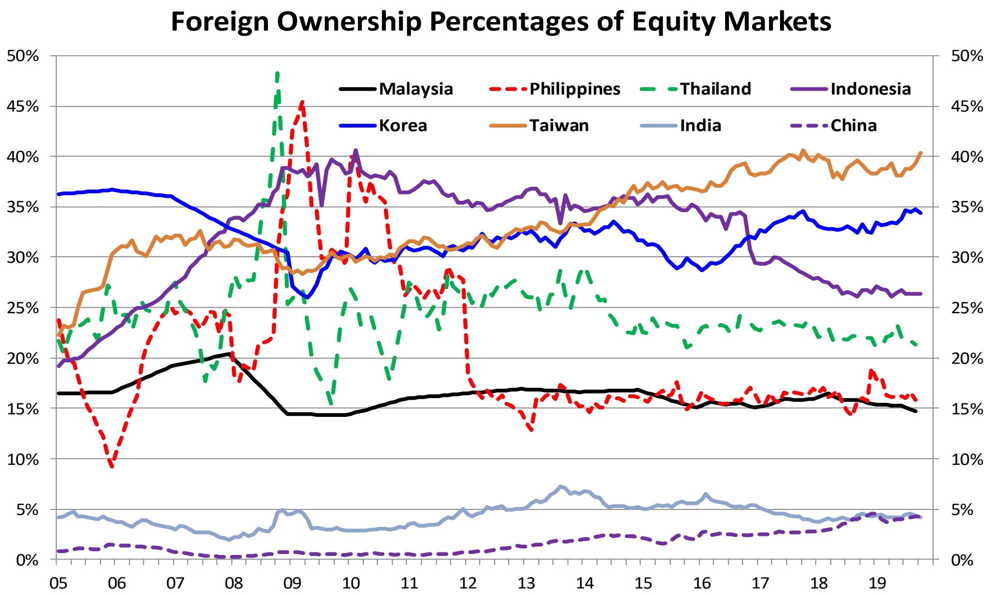
The PRC could, in theory, help kill two birds with one stone by encouraging its firms to issue far greater quantities of bonds and shares overseas *denominated in RMB*. Hong Kong would seem to be the logical place to start and the process could be turbo-charged by switching the currency of new or even existing Chinese domestically-focussed business listings into RMB while simultaneously encouraging the deepening of local currency hedging

The PRC could, in theory, help kill two birds with one stone by encouraging its firms to issue far greater quantities of bonds and shares overseas *denominated in RMB*

[16] This is not an unreasonable bet based on contemporary attitudes to personal, digital security seen worldwide. In China privacy can be thought of as a public good while in the US privacy appears to have been privatised. Europe seems to be somewhere in the middle. Being a paranoid, curmudgeon like your correspondent who seeks to minimise his digital footprint and eschews almost all forms of social media, is hard work.

markets.[17] Nevertheless, existential and dominant issues of control are always hovering in the background.



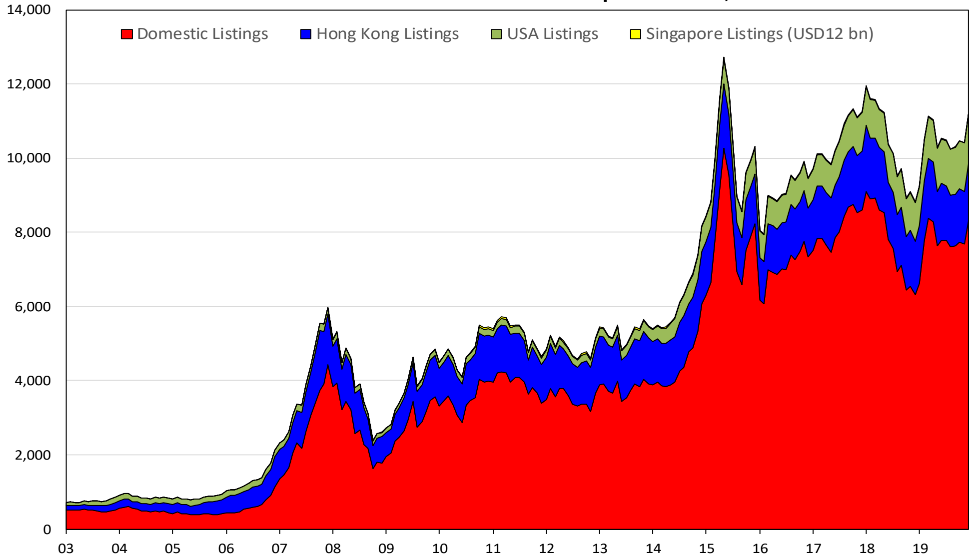


[17] Aside from market development and volume gains for the SAR, redenomination would also potentially reduce regular money market distortions emanating from the outsized size of the stock market relative to local HKD transactional demand.

Chinese offshore stock market listings already total around USD3 trillion equivalent to about 40% of the domestic markets' capitalisation. Prior to 2014 the HKEX was overwhelmingly dominant but because of its unwillingness to embrace dual-class share structures, which allow companies to issue shares with different voting rights, Chinese tech companies tended to gravitate towards the NYSE and NASDAQ. In April 2018, the HKEX relented and changed its rules to permit "innovative" companies to list with dual-class structures.

Chinese offshore stock market listings already total around USD3 trillion equivalent to about 40% of the domestic markets' capitalisation

China Onshore and Offshore Stock Market Capitalisations, USD billion



The timing seems to have been good if the recent Alibaba listing is anything to go by. Although the company might have been prompted by the rule change to pursue its secondary listing, not to mention the chance for China-Hong Kong Stock Connect inclusion, the proposed US Equitable Act[18] must be focussing minds. Were this Act to come into force, then the importance of Hong Kong's stock exchange as a source for China listings will only increase further.[19]

Were the US Equitable Act to come into force, then the importance of Hong Kong's stock exchange as a source for China listings will only increase further

[18] On the face of it, demanding that foreign companies wanting to list on US exchanges should submit themselves to the same transparency and accountancy standards as any other company is not an unreasonable one. The ESG card, if one believes that this is anything more than virtue signalling, is a very real threat to the practices of many Chinese companies.

[19] I suspect, though I have no proof, that diversification of alternative listing venues was one of the drivers for the HKEX's recent and failed bid for the LSE.

Another area of relative strength for Hong Kong stems from the HKEX having done a pretty good job of rejecting potential Mainland Chinese frauds over the years.[20] I do not have firm figures to hand but my perception is that the number of China-related disasters relative to the total has been relatively meagre due to the stock exchange onerous listing requirements. If you squint at the previous chart you will just about be able to make out Singapore's share of the overseas Chinese company listings market. As for other exchanges that have put out the welcome mat to Chinese counters, I have not been able to source any time series.

Another area of relative strength for Hong Kong stems from the HKEX having done a pretty good job of rejecting potential Mainland Chinese frauds over the years

Nevertheless, the amounts raised have been puny while the companies that decided to list on these bourses, often ones that could never hope to meet the HKEX's listing stipulations, have been plagued by quality issues. London seems to be having another go with the launch last year of Shanghai-London Stock Connect. Hitherto only a single Chinese company has issued GDRs on the exchange though a couple of others are supposedly still preparing to do the same despite recent claims, quickly denied by the China Securities Regulatory Commission or CSRC, that Beijing had put a suspension on the process. Let us hope the quality of listings is somewhat better than those who contributed to the Alternative Investment Market (AIM) bubble of a decade ago.[21] At its peak in 2008, around 70 Chinese were listed but the market has atrophied ever since and, today, only one Chinese company – a bio-pharma company in the Li Kashing Hutchison stable – has a market cap above GBP1 billion.

The amounts raised on other bourses aside from the US have been puny and have been plagued by quality issues

The charts overleaf on the offshore debt markets complete this review. You will note the latest surge in offshore borrowing and security issuance coincides with China's clamp down on alternative sources of domestic funding. This is unlikely to end well for many investors as those of you who recall the ITICs would probably concur. Again though, the amount issued in RMB offshore is puny – USD60 billion or so equivalent according to the IMF – of which half is domiciled in Hong Kong.

China's latest surge in offshore borrowing and security issuance coincides with its clamp down on alternative sources of domestic funding

[20] The exchange and regulators have a less than stellar record with smaller Hong Kong counters over the years https://www.scmp.com/business/companies/article/3010454/hong-kong-charges-alleged-mastermind-citys-largest-financial

[21] Arguably Toronto wins the prize, in a competitive field with the S-Chips and AIM, of the lowest quality of all. there were 50 or so mainly resource-focussed companies with a market cap around CAD13 billion listed in 2010. Today there are only 10 or so with a combined market capitalisation of less than CAD 5 billion.

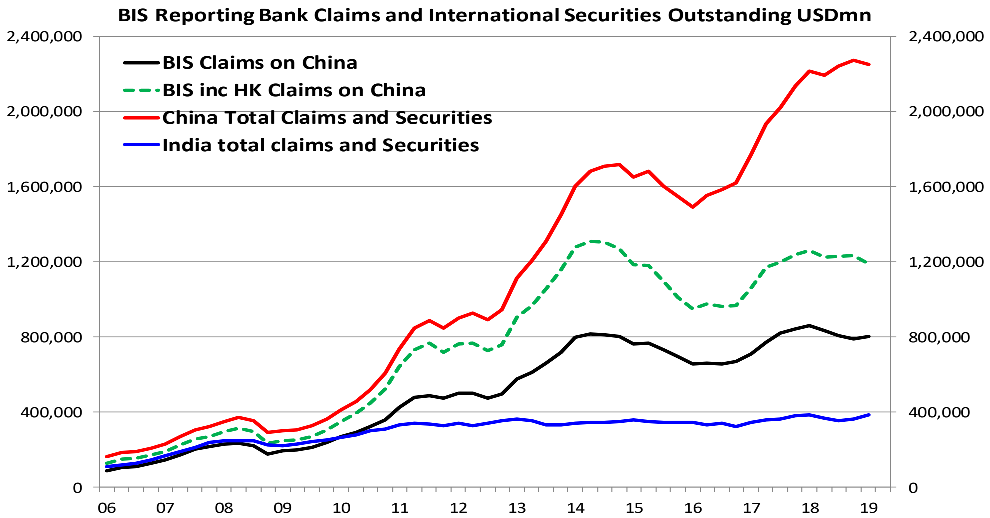
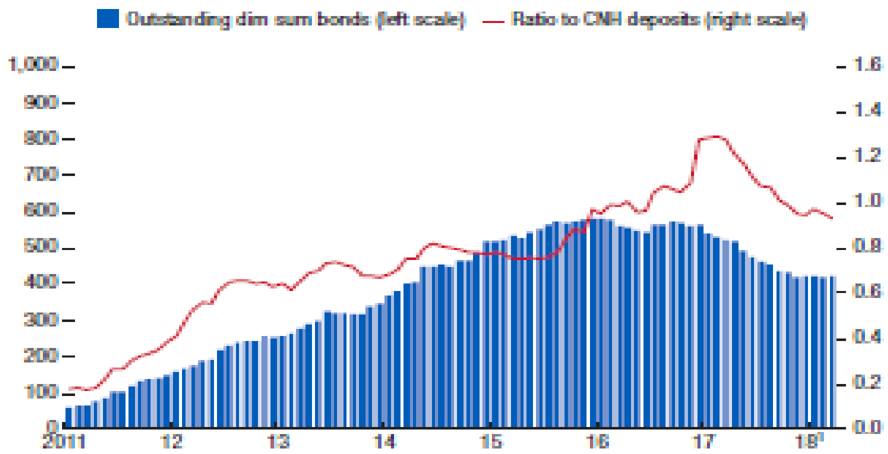


Figure 15.1. Outstanding Dim Sum Bonds, 2011–18
(Billions of renminbi, left scale; percent, right scale)



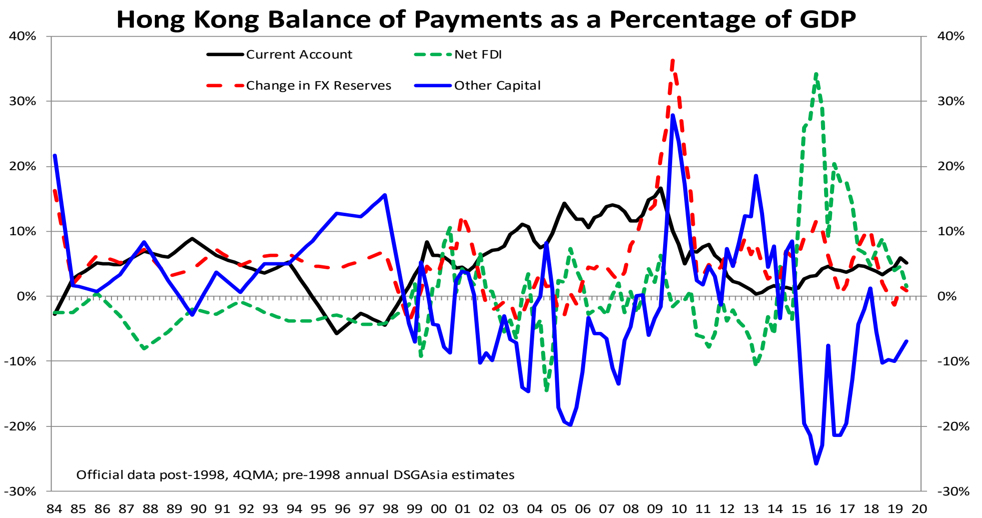
Sources: Bloomberg L.P.; CEIC data; and authors' calculations.
Note: CNH deposits refer to offshore renminbi deposits in Hong Kong SAR.
[1] Data for 2018 are through March.

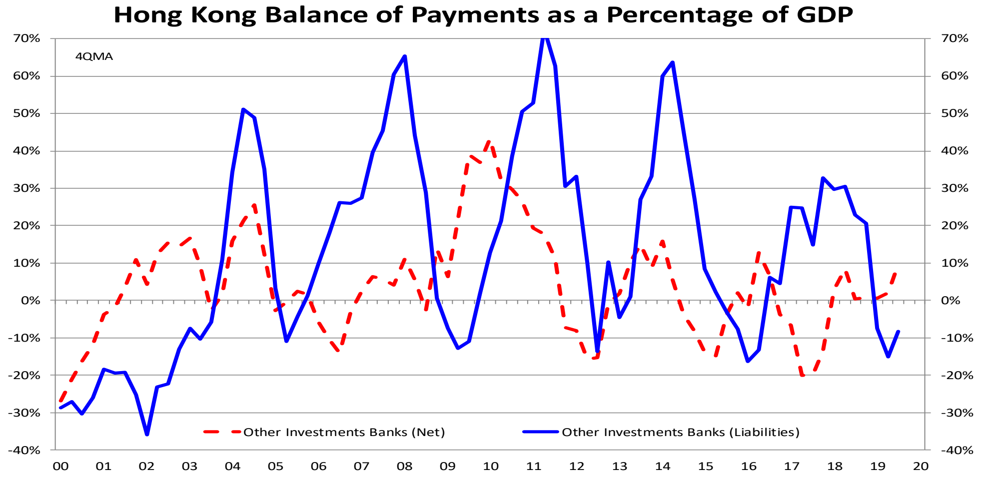
Source: "The Future of China's Bond Market", International Monetary Fund, 2019.

To summarise, Hong Kong remains indispensable at this juncture both as a controlled funnel for financial flows in and out of the Mainland, and for the elite to diversify their assets, kosher or otherwise. Furthermore, there is little evidence that capital is fleeing the SAR in size. A small open economy with open capital accounts will tend to have highly volatile and messy balance of payments flows and Hong Kong certainly ticks all these boxes. We only have BoP figures up to the end of Q3, but they show nothing abnormal or untoward

There is little evidence that capital is fleeing the SAR in size

has transpired.[22] Meanwhile the lack of volatility in the local HKD currency and interest rate markets suggests that although local citizens have experienced day-to-day disruption and businesses in certain sectors are hurting badly, there is no broad-based rush for the exits. The continued levitation of the world's most overvalued property would imply much the same.

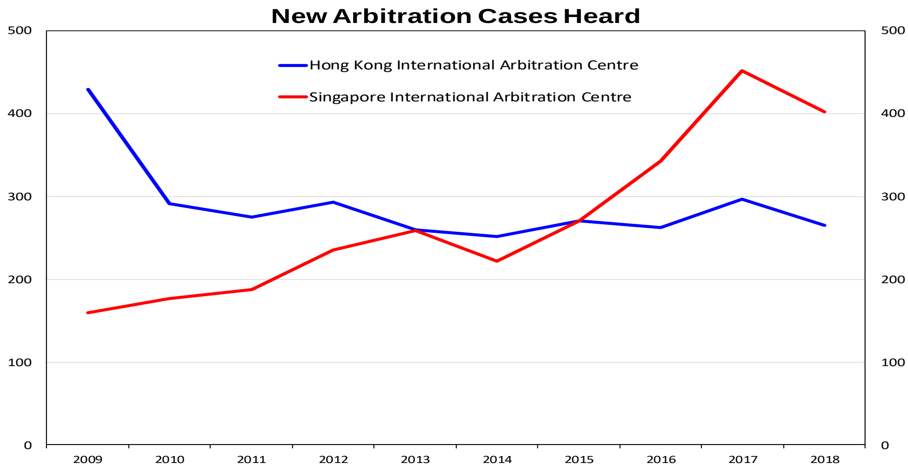




[22] For the technical economics geeks out there, should a local resident decide to move the custody of his assets to another jurisdiction then this will show up in a reduction in local banks' liabilities. However, if these are already denominated in foreign currency then there will be zero FX impact. Anecdotes suggest that such re-domiciling is starting but it seems to be a building seepage rather than a flood at this juncture.

There are a number of ways that the SAR could lose its privileged perch of course. Great financial centres and city states (I make no sovereignty implications here) have come and gone over the centuries and historians a century hence could be writing about Hong Kong's descent into irrelevance. However, for this process to accelerate alarmingly some or all of at least three things will need to happen. First, and most optimistically, the Mainland could move rapidly towards developing a proper rule of law, transparent and free financial markets and fully open capital accounts. This hardly seems consistent with Leninist mores and I am not holding my breath, but never say never.

There are a number of ways that the SAR could lose its privileged perch of course



Second, the Party will not be able to help itself and Mainland practices will increasingly seep into the local legal system. Hitherto, the CPC's judicial interventions have been overwhelmingly restricted to the civil liberties and political rights spheres – alarming enough for the local population but, so far, largely irrelevant for amoral international financial capital. Were the courts start to be perceived to be ruling in a systematically biased manner in favour of Mainland entities, Hong Kong's unique attractions could be rapidly eroded.[23] There is no evidence whatsoever that this has occurred though the Party *force majeure* insertion of its explicitly dominant role into the articles of association of PRC listed companies in Hong Kong in 2017 potentially provided a worrying precedence. Some foreign companies are taking no chances and, anecdotally, are seeking to write new contracts under other jurisdictions than the SAR. Arbitration cases are shifting too at the margin.

Great financial centres and city states (I make no sovereignty implications here) have come and gone over the centuries and historians a century hence could be writing about Hong Kong's descent into irrelevance

[23] I discussed such issues in greater detail in "The Hong Kong Dollar is a Side Show", June 6th 2019.

Rattus Sinicus

Finally, we could see a complete breakdown in law and order, troops on the streets, martial law, etc. I would put this as an extremely low probability at this stage but the authorities' responses, both local and from across the border, have hardly inspired confidence that there has been any real effort to understand or deal with the citizenry's very real grievances. The removal of the hapless Liaison Office head, Wang Zhimin and his replacement by "Shanxi-fixer"[24] Luo Huining offers a chance for some sort of a reset and change in tactics. I am happy to discuss such issues offline should people wish to get in touch.

The appointment of Luo Huining offers a chance for some sort of a reset and change in tactics

Oh shoot (sic)!
There goes the charabang
Looks like I'm gonna be stuck here the whole summer
Well, what a bummer
I can think of a lot worse places to be
Like down in the streets
Or down in the sewer
Or even on the end of a skewer

[24] Anyone that survives this posting and comes out with merit must have something going for him.

Rattus Sinicus