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GOVERNMENT PENSION FUND GLOBAL EMERGING MARKET INVESTMENTS

The share of global GDP produced by emerging markets is 31 percent. The market cap of emerging markets' stocks is only 12 percent in the FTSE index. Why? Because there are severe restrictions on stocks foreigners can hold. And the index only "reflects the free-float investable universe from the perspective of a global investor."¹

In China A-shares are almost inaccessible to foreign investors. And shares in state owned enterprises are to a great extent kept in the drawers, i.e. not traded. Like the Hydro-model we used to talk about in Norway. Or the DnB NOR model of a more recent vintage.

Government Pension Fund Global (GPF) has about 50 percent of its stock investments in Europe. The fund has decided that exchange rate concerns are less relevant for the global allocation of funds. Thus, GPF is considering to reallocate funds; reducing exposure in Europe and increasing exposure in emerging markets.

In my remarks which are from an economist's vantage point, I will focus on China.

Convertibility of the yuan

In 1995 the Chinese yuan became convertible for transactions on the current account, and a unified exchange rate system was put in place. The yuan was pegged to the dollar at 8,28:1 as of 1996 and until July 2005. A one-shot revaluation of some 2 percent then took place, followed by a managed float. After the demise of Lehman Brothers the steady appreciation of the yuan was put on hold for some time. Then it continued. Currently the price of one dollar is about 6,35 yuan.

However, the yuan is not convertible for transactions on the capital account, despite pressure from the Western world, in particular the US. From a Chinese point of view, why should they allow full capital account convertibility? Then, something has to give; the interest rate and/or the exchange rate. The well known trilemma in international finance tells us that you can have two out of the following three:

¹ Page 5 in "Emerging markets", by Elroy Dimson, Paul Marsh and Mike Stauton, in *Global Investment Returns Yearbook 2010*, by the same authors. A final reason is the lack of proportionality between GDP and market cap across countries.

- Autonomous interest rate policy (or domestic monetary policy)
- Fixed or managed exchange rate
- Free capital mobility (or capital account convertibility)

The idea that markets know best what the equilibrium exchange rate is, the IMF as of late has become a bit skeptical to. China has been skeptical for a long time. Better to keep important prices under control, like the exchange rate and the rate of interest. China saves more than she needs. Convertibility on the capital account she can do nicely without.

Financial stability and capital account convertibility

In China five State Owned Banks have about 60 percent of the market. They have been “beefed up” by foreign strategic partners since 2003. And then IPOs took place. However, only a minority of shares are traded and owned privately, i.e. the Hydro model applies.

Now, China used her State Owned Banks quite aggressively during the financial crises. In the course of 27 months (November 2008 through 2010) China added the equivalent of 14 percent of GDP to a stimulus program. Most of that money were loans from State Owned Banks or to other public entities. Some of those loans, perhaps not a small share, will go bad. Who will foot that bill? Not the Germans. But Chinese depositors. Why? Because of financial repression, i.e. ceilings are set for deposit rates. For the time being those rates are below the current rate of inflation, taxing the depositors through a negative real return.

For lending rates floors are applied. Thus, a handsome interest rate margin is locked in. By pure fiat. This bodes badly for the allocation of capital, but makes for increased financial stability. Losses can be taken without banks going down the drain. This is exactly the problem with the euro; no agreement on how to distribute losses. And no price to change – the exchange rate is gone and the rate of interest is set in Frankfurt – to have the economies of Club-Med countries adjust properly.

By allowing capital account convertibility, and foreign financial firms establishing themselves in China, financial repression is hard to maintain. Currently about two percent of banks’ balance sheets are in foreign banks.

Shanghai as an international financial center by 2020

A couple of years ago Beijing decided that Shanghai should become an international financial center by 2020, thus reviving her old glory of the 1920s and 1930s as the hub for high finance.

Does Shanghai as a financial center necessitate capital account convertibility? It depends upon what currencies China would like to be a financial center for. Singapore and Hong Kong do much business in USD, Hong Kong also in her own dollars, whereas the Singaporean dollar is less internationalized. Hong Kong has a currency board to the USD, i.e. 7,78 HK\$ is equal to one US\$. The credibility of that commitment got a serious boost after Tiger Funds and others lost their shirt under the Asian financial crisis, unsuccessfully trying to break this commitment.

Quite likely the yuan will become more internationalized over the next five to ten years. We already see signs of this. Bilateral agreements between China and other countries that trade may be invoiced and settled in yuan. And foreign companies are raising money in the yuan-market in Hong Kong, by issuing yuan-denominated bonds, as McDonald's did about a year ago. However, the yuan raised in Hong Kong McDonald's cannot freely transfer to mainland China.

A fully convertible yuan, what would that mean?

Now, assume that China allows full convertibility of its currency, for foreigners as well as for domestic residents. By doing so, the fixed or managed exchange rate is done away with. Also, in the spirit of truly entering the scene of global finance, China allows fierce international competition in domestic capital markets. On top of this, stocks kept in drawers are put out in the open, for all to buy – and sell.

Then, most people seem to fancy, the yuan would strengthen and stock prices in China would increase. However, this is a two way street. What about all those Chinese sitting on Chinese assets only? An outflow of yuan would follow. Which flow is the bigger one? That would determine the effects on exchange rates and on asset prices in China as well as abroad.

A complete liberalization of the Chinese financial markets would imply an opening up for investments in an economy that by 2020 supposedly is the largest in the world. GPFG could quite easily increase her shares of Chinese stocks and fixed interest instruments to the desired levels.

GPFG in China today

China has a quota system for foreign investors, Qualified Foreign Institutional Investors (QFII), initiated in 2002. Today a total of 21 billion dollars have been allocated to 103 investors. GPFG joined the club in 2006. It has been allocated a quota of 800 million dollars, which is next to nothing when total wealth is more than 500 billion dollars.

With those 800 million dollars the GPFG can operate like locals, i.e. buy A-shares. The money has been put into stocks as well as into fixed interest rate instruments.

How to increase exposure to the Chinese stock market

It is, I presume, some years down the road before China opens up her capital markets. If she ever does.² In the meantime, how could GPFG obtain the desired increased exposure to the Chinese stock market? I guess by analyzing carefully foreign companies' exposure to the Chinese market a Chinese portfolio of some sort could be worked out. After all, China has received foreign direct investments to the tune of about one thousand billion dollars over the last fifteen years.

Now, what then is most detrimental to the legacy of the fund; being underweighted in Chinese assets, when these assets do exceedingly well? Or being over weighted in such assets if they do exceedingly poor? That must also be a concern for those running the Fund.

Conclusions and Recommendations

GPFG should try to put more money into the Chinese market. But access is not easy. My guess is that it will take a long time before China opens up her capital market. Perhaps then, better to find indirect exposure, cf. the discussion above? Provided that working out a suitable Chinese portfolio along those lines could be properly done.

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² Under the current system China can almost pick and chose as far as FDIs are concerned. Look at Siemens and Alstom. To participate in the largest market for production of high speed trains, these two European companies had to share technologies with Chinese firms. Now they compete with these Chinese firms on foreign markets. In Saudia-Arabia, Siemens recently withdrew its offer to build a TGV from Mekka to Medina and instead joined forces with a Chinese-led consortium. Why? Because the likelihood of obtaining future contracts for rapid trains *in China* thereby increases considerably.