



One Currency, Two Systems

By The Hamon Investment Team

China's recent announcement of new measures for the management of the yuan further relaxes currency controls and brings Beijing a step closer to internationalizing the yuan.

The first announcement plans to allow five major Chinese cities to trade and settle through their counterparts in Hong Kong in yuan (also known as renminbi, or RMB). The proposal of the Yuan Trade Settlement Scheme (YTSS) is a very significant step and comes 12 years after the handover of Hong Kong to China. Although full details of the pilot scheme are still to be announced, the framework has been laid out, which will greatly assist importers and exporters from foreign exchange risks and reduce China's dependency on the U.S. dollar. This will be especially important to banks in Hong Kong, providing them with new sources of revenue and growth potential.

The second announcement allows HSBC and Bank of East Asia to issue RMB bonds offshore in Hong Kong. The Bank of East Asia's issuance of 1 billion yuan in bonds with a yearly coupon of 2.8% to retail investors, reflects the appetite for exposure to the yuan and confidence it will appreciate against the Hong Kong dollar.

For China, the offshore bond scheme underlines the importance of Hong Kong and its role acting as a controllable offshore market to gradually internationalize the yuan. Since 2004, Hong Kong banks have been allowed to have limited RMB deposits and issue credit cards. However this YTSS will offer greatly expanded roles for the financial sector in Hong Kong.

Responding to Financial Crises

There is a Chinese expression *liu an hua ming*, with a literal meaning "beautiful forestry follows a dim willow path," or "prosperity follows adversity." In the last 10 years, China has demonstrated its ability to preserve economic momentum through market recessions, using these downturns to introduce modernization and expansion while making the economy competitive.

During the Asian Financial crisis of 1997, Premier Zhu Rongji pushed China into the World Trade Organization despite domestic fears of the consequences.

China invited foreign investment into its major state owned corporations and encouraged competition and modernization, resulting in foreign direct investment flowing into China. In 1998, many Asian countries restructured and struggled, but China modernized and grew at an annualized 7.8% rate, while the Asean (Assn. of Southeast Asian Nations) countries contracted 7.9%.

Following the Asian financial crisis and the bursting of the tech bubble, Hong Kong struggled with high unemployment and a weak property market. As a result, Hong Kong turned to China to open its border, setting the stage for the Closer Economic Partnership Agreement (CEPA). Allowing for easier cross border investment and trade, CEPA helped Hong Kong recover and increased its integration into Southern China, expanding investments into manufacturing and property while reducing costs. Establishing itself as an extremely efficient investment hub for China, Hong Kong opened its stock market, allowing China's state owned enterprises (SOE) to list, helping firms gain access to international investors and funding.

The subsequent years saw Hong Kong raise money for all the major Chinese banks and put them in their currently strong financial position.

The current global financial crisis has dramatically decelerated China's export industry. However, proactive fiscal policies and a massive stimulus spending buoyed economic stability despite the slowdown. China is also using this downturn to improve cross-strait relations with Taiwan, which will also strengthen the recovery for both countries, especially for Taiwan, which is normally an export-heavy economy. Opening Taiwan's economy to China should produce results similar to Hong Kong's during its recovery from the recession and the SARS epidemic in 2003. During that period, money flows from the Mainland helped revive external and domestic demand following a deflationary period.

Developments from the Current Global Financial Crisis

We believe that the current economic downturn will accelerate China's plans for economic liberalization of its domestic economy in several ways over the next few years:

RMB Swaps and Bilateral Trade will continue to grow for China: Until the government freely floats the RMB, currency swaps and bilateral trade will be an important element for developing countries to benefit on China's growth. Currency swaps with China have been important for trading countries like Argentina, Belarus, Indonesia, Malaysia, and South Korea, with China and Brazil proposing trade settlement in yuan and reais rather than the U.S. dollar.

The emergence of "Shang Kong" (Shanghai/Hong Kong): China has unveiled ambitious blueprints to transform Shanghai into the region's international finance center, with speculation of replacing Hong Kong. Hong Kong has generally benefited as a gateway to raise foreign capital to enter China, and remains too important as a finance center for Shanghai to replace. Instead, we foresee the rise of "Shang Kong," where Shanghai and Hong Kong will work as partners rather than competitors.

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The RMB will probably replace Macau's Pataca (MOP): More Asian banks will allow RMB currency to settle financial transactions, but Macau is in a position to fully replace the Pataca (MOP), its domestic money. Given stronger relations with China than Portugal, along with growing Chinese trade and integration with China, Macau's economy will slowly adopt the RMB, which will likely become the main currency in Macau, and the MOP will gradually be phased out.

The end of 10%+ GDP for China: Despite the commendable achievements of China's years of high GDP, such rapid economic growth places a huge strain on social infrastructure, such as environmental protection and rapid urbanization. China will have to approach a more balanced, responsible, sustainable growth strategy. Additionally, China's 10%+ GDP growth occurred during bullish export markets in America and Europe, suggesting that a contracting or stagnant western market means that China will focus on implementing much needed domestic modernizing and infrastructure for its growth. China will likely pursue sustainable, high single-digit growth with balanced job growth across China.

More Asean countries accept the RMB: The development of the RMB as an international currency represents a significant loosening of China's strict capital controls, under which the currency does not freely float or trade. With the YTSS (Yuan Trade Settlement Scheme), however, more Asean countries should be attracted to circulate and buy RMB-denominated assets. For such countries, the use of RMB financial products should help increase foreign direct investment and protect against inflation.

Taiwan: Warming cross-strait relations between Mainland China and Taiwan have already begun expanding economic opportunities for both countries, including new capital raising ventures and M&A activity. Under the current agreement, Taiwan is expected to open 100 industries and projects to Chinese investors, further strengthening the financial sectors for both economies.

China Mobile's 12% purchase of Taiwan's Far EastTone was the first Mainland firm to invest in the Island's telecommunication business. While Taiwan still restricts Chinese investments in telecommunications, the ban is expected to be lifted soon — a win-win outcome that allows Taiwan to reach China's broad market, while the Mainland can acquire the Island's software resources.

Conclusion

We are very excited about how the expanded role of the RMB can help improve financial and trade liquidity, and boost the prospects for China and Asia, especially in periods of downturn. We consider China's economic management to be extremely sound. It is especially wise for the government to be focusing on building infrastructure now, as a means of revitalizing the domestic economy and addressing the urgent need for modernization.



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