Asia reorders the global financial system

May 2015
Cover story
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Does the new China-led Asian Infrastructure Investment Bank really mark an end to the existing western-dominated financial order? Our lead feature looks at both the economics and geopolitics behind this question.
konzept
Editorial
Welcome to the fourth issue of Konzept and thank you for all the feedback and support since the magazine was launched in November. We are pleased there seems to be an insatiable desire for thought-provoking, insightful research written in a clear and enjoyable style. As ever, please send us your ideas and suggestions for articles to the email address below.

In this edition we devote the front of the magazine to the theme of global finance while the long features in our middle pages are all about Asia. Given the recent history, it is no surprise that regulation comes to dominate many of the finance related articles. Naturally, however, we approach the topic from unusual viewpoints. For example, one of Deutsche Bank’s top rated banks analyst worries that much reporting these days is too complex to comprehend, even for the professionals. Our mining sector analyst draws on his past experience of working for a mining company to draw lessons for fixing the banking industry’s compliance issues. Still on the topic of finance we also have pieces exploring the impact of recently instituted TLAC rules and whether or not insurers pose a systemic risk. Finally a bit a magic – credit investment magic that is, as we dig into the seemingly unusual performance of bonds following a ratings downgrade.

Turning to Asia our cover story examines the Asian Infrastructure Investment Bank, the multilateral lender that has been front page news ever since a number of western countries broke ranks with America to join earlier in the year. Some fear the rise of China-led institutions poses a direct challenge to the established order led by the Bretton Woods institutions like the IMF and the World Bank. Peter Garber, who used to work at the IMF himself, explains both the economics and geopolitics behind the AIIB to conclude that while its emergence was inevitable, its impact will be less than feared.

That is followed by two fascinating features on India: the first from our Asian chief economist Taimur Baig on the country’s thriving informal economy and the second one examining whether e-commerce can be as transformational in India as it was in China. We also consider the future of Singapore after the death of Lee Kuan Yew in March and finally consider the path China has taken towards financial market liberalisation.

And don’t worry the back section of the magazine is full of the usual favourites. We review two books on Chinese economist and reformer Wu Jinglian, our conference spy reports back from a shipping summit and Professor Forrest Capie explained to his Ideas lab audience that historical periods of light or non-existent bank regulation have coincided with the fewest crises. The infographic crunches travel data between the top two cities in selected Asian countries – the most connected cities may surprise you.

All food for thought, now enjoy the banquet!

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To send feedback, or to contact any of the authors, please get in touch via your usual Deutsche Bank representative, or write to the team at research.haus@db.com.
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Although it is often easy to characterise the relationship between banks and regulators as adversarial, especially so since the financial crisis, the truth is they mostly want the same things: a stable financial system, prevent banks from failing, a reduction of the damage caused by cyclicality, and, in the broadest sense, an environment that allows for the efficient functioning of markets.

Rather the disagreements between banks and regulators tend to come in the means of achieving these ends. A good example of this is market discipline. Banks often play the role of the champions of free markets, and argue against excessive regulation to prevent these markets from becoming distorted. But in my experience of talking with regulators, they too want free markets, and indeed see them as an essential part of the overall regulatory process. In fact, market discipline on banks is considered the third of the three-pillar regulatory system of supervising banks.

All of which raises an interesting question, especially for those such as me who spend their lives trying to understand banks. If regulators think that market discipline is essential, and banks are the champions of free markets as the best way to allocate capital, why is there still such controversy between them over bank disclosures? Surely it is in the interest of everyone to have the clearest, simplest and most comprehensible reported accounts and disclosures possible. Certainly investors and we bank analysts would appreciate it.

Yet the exact opposite is occurring. Much bank reporting has now become so complex it has spiralled out of all control and meaning. Last year’s annual report and accounts for UBS, for example, ran to 868 pages. That is more than a threefold increase on the Swiss bank’s 2006
annual report. What is more, the calculations behind many bank disclosures these days are opaque and mostly useless to an outsider because they are deeply technical. Even professional equity analysts struggle to understand disclosures running across the whole range of banking businesses, from traditional asset and liability management to trading book and operational risk, including different methodologies for valuation, provisioning and so on.

Newer and less experienced observers, meanwhile, have faced an additional problem in recent years because of the cumulative impact of new disclosure requirements. Many banks around the world now routinely include extensive information on, say, securitisations – a problem area that really only emerged out of the last crisis. Another example is lenders that also disclose information about exposures to peripheral European countries. It seems to be ever easier to add new or incremental disclosure requirements, but few are ever removed.

One of the biggest problems with this explosion of compliance with disclosure requirements is that it hinders the market’s ability to enforce discipline on banks, especially in their riskiest areas. If everything is considered to be a risk factor, then nothing really is. While much smaller than today’s effort, that 2006 annual report for UBS still came to 256 pages, yet post-crisis we now know in retrospect that all those pages did not contain the right information. To be sure, UBS is a much safer institution today than it was pre-crisis, as are all banks to be fair. But it was not the threefold increase in page count that has caused this improvement. And I suspect that if given both the 2006 and 2014 versions of UBS’s annual report to analyse, most outsiders with no knowledge of the intervening years would not be able to pick the safer institution.

Nor is this problem merely theoretical. The reality is that banks face a higher cost of equity than the broader market. By my calculations the current implied required return for European banks is 9.5 per cent, which, given a risk-free rate of more or less zero, implies that the banking sector beta is high versus history as well as against other sectors. This is surely in part down to the black box nature of the industry. The one year forward price to earnings ratio relative to the market tells the same story – banks are at the bottom of the range.

Even within the sector, I find evidence of the market’s preference for transparency. When I researched this issue last year, I found a persistent valuation premium of roughly 0.2 times tangible net asset value for simple banks. The hurdle that complex banks face to educate the potential investor base is not insurmountable, but observable market discounts tell us that the hurdle is not – as yet – being cleared.

How can this problem of complexity be resolved? The good news is that both regulators and banks want capital markets to play a role in allocating capital, necessarily including the banks themselves. Of course in order for the market to do this – judging risk while enforcing discipline on banks – information is needed. But this does not mean more data. Banks are disclosing too much information already. What is needed is less disclosure of more standardised information.

The Basel Committee published a paper in January setting out revised requirements for Pillar 3 disclosures (to enable the market to enforce discipline on regulatory issues). This called for five principles to be observed: disclosures should be clear, comprehensive, meaningful to users, consistent over time and comparable across banks. These principles would fit with banks disclosing more information on regulatory capital requirements based on the Basel Committee’s Standardised Approach, rather than the impenetrable Internal Ratings Based approach used by most of the large banks. This may not be the best solution for the banks, but the onus is also on them to come up with an alternative.

The industry cannot wait around hoping for regulators to take the lead here. If banks do not simplify their disclosures and improve the functioning of Pillar 3 market discipline themselves, I believe the market will continue to punish banks with valuation discounts versus other industries.
inspectors but the bottom-line remained that being a miner was a dangerous job where people were routinely injured and sometimes killed. Accidents were regulated, if you like, by the government of the country in which the mine was located. Perceived breaches in safety or accidents often resulted in fines and in general the industry considered these fines as an ongoing cost. After all, mining was dangerous – what did governments expect? Nowadays, banks speak in a similar tone about doing business in America for instance.

Over time the fines for mining accidents got bigger but the accident rates did not improve significantly. Finally regulators and governments realised that mining companies were treating fines as a cost of doing business and not as a deterrent, so they decided to up the ante. Forced operation closures were introduced along with even bigger fines. Suddenly the industry decided that safety was indeed a top priority or at the very least managers wanted to show the regulators that it was taking the issue seriously. Hence mining companies threw money and resources at the problem, just as the banking industry has responded since the financial crisis.

I remember in those years the mining industry hired large numbers of safety specialists, managers, and even general managers, and these new employees were intelligent, hard-working and diligent. Safety became a religion to the extent that any proposal that was rooted in improving safety was quickly passed, often with
economic arguments put aside. New safety staff performed their tasks with vigour — guarding was put on equipment, workplaces were demarked and safety equipment beefed-up. We then documented all our new work practices and had everyone tested and signed-off. Paperwork was neatly filed away on the shelves. Leadership teams felt satisfied. Everything was in hand with safety personnel installed and accountable. Yes, costs went up and production was impacted, but safety was the key priority after all.

Unfortunately, however, safety performance remained well short of expectations. Despite the billions spent, years wasted, specialists employed, documentation filed, not to mention the lost productivity, the industry was still hurting a lot of people. The digging equivalent of a top to bottom compliance overhaul had failed to work.

So what happened? And more pertinently, how did the mining companies eventually manage to get their safety problems under control? The answer is they completely changed tack and turned to another industry – and in my previous employer’s case, one company in particular – for help. DuPont had an excellent safety record and was prepared to offer some consultation. When representatives came to my own operation to teach us how to become safe they brought videos of their own sites. We sat down with them and watched the videos intently. Was there an optimal solution for guarding equipment? Was there an ideal safety team structure?

The videos were a complete shock to us. Their operations had a distinct lack of guarding, little demarcation and an obvious shortfall in safety gear. In fact they looked pretty unsafe to our eyes. But we soon learned that DuPont’s secret had nothing to do with overbearing rules and processes. Rather it was much simpler: improved safety was all about behaviour. In DuPont’s view, correct behaviour could not be achieved by machine guarding, box ticking or via independent safety specialists. Safety had to become the key responsibility of each and every leader; it could not be delegated.

DuPont told us it demanded safe behaviour from every employee and had zero tolerance of poor behaviour. The smallest breaches of its golden rules meant, for example, that new employees were not hired at the end of their probation periods or that existing employees were quickly fired.

Moreover, operating standards were considered to be what occurred in the workplace rather than written in office manuals. Leaders were required to discuss safety issues every day with their teams and audit these standards in the workplace. This did not mean formalised meetings. Instead every leader from the chief executive to the supervisor would spend time each day on site having frank discussions with employees about risks. After all, DuPont told us, the miners themselves know best where the risks are and how to prevent them, not external auditors.

To its credit the mining industry saw the light and tried to become more like DuPont. Accountability for safety moved upward to operating leaders and higher. Management teams started to treat safety as a behavioural tenet rather than a separate activity within the company. Safety performance quickly improved throughout the sector and has continued to do so to this day.

For the few of us who have worked in both mining and finance the parallels between the two industries are clear. Many firms are at risk of confusing compliance as a function with compliance as a culture. What finance needs is more compliance as a verb – we need our staff to be compliant with our values and the law. More often than not, however, one hears about compliance the noun – the compliance team, the compliance officer or simply just compliance.

Much like the mining industry two decades ago, banks have hired more and more compliance specialists and are building ever more complicated compliance systems. Both would be unnecessary if workers were all compliant. Of course, much is being demanded by regulators. But they too should ponder whether some money may be better spent hiring psychologists to identify people most likely to breach requirements and remove them from the industry (or at least move them to less hazardous work functions) than hiring more compliance officers.

Likewise, the lesson from mining is that leaders in the banking industry must take direct accountability for the compliance of their organisations. Accountability cannot be abrogated and passed on to a compliance team. Behaviour starts at the top and trickles down to the operating personnel that will be able to identify compliance risks far more ably than any external observer. Leaders must ask the right questions of their teams, on the floor, regularly, and as a core part of their management role.

If burly mining companies can transform their compliance cultures via the chemical sector, it surely won’t hurt for the financial industry in turn to heed some lessons from us diggers.
Are insurers a systemic risk?

The Financial Stability Board certainly thinks so. So does its American counterpart – the Financial Stability Oversight Council – which has designated three US insurers as Systemically Important Financial Institutions that should be subject to additional regulatory oversight and capital requirements. It is still early in the process, and there is as yet little meaningful information on what this may mean for US insurers. But are they systemically risky or not? Last December Congress passed an amendment to the Dodd-Frank Act to clarify that regulated insurance companies did not have to be treated as banks and noting that there was broad agreement across the academic and practitioner literature that insurance companies do not pose systemic risk in the sense that banks do. Hammering the point home, the Government Accountability Office reported in a comprehensive 2013 study that the financial crisis generally had a limited impact on insurers and policyholders outside of a few specific situations.2

There was of course AIG, but the issue there was concentrated in the Financial Products Group, which was part of the holding company and not a regulated insurance unit. In fact, the regulated insurance units of AIG were not endangered by the events at the Financial Products Group. There were also severe problems at some insurers that had sold guaranteed annuities tied to equities, and two companies ended up receiving funds from the Troubled Asset Relief Program.3 These companies were affected by systemic risk, but it is less clear they contributed to the spreading of systemic risk.

The financial guaranty sector (bond and mortgage insurance) was hard-hit, but regulators have long required these types of companies to operate in a monoline structure – one that requires the insurer dedicate its capital to pay claims on a single line of business, as opposed to a multiline structure where capital can be paid on claims on all of its insurance lines – specifically to limit the risk of fallout to other markets or companies should they get in trouble. The bond insurers arguably contributed to the financial crisis more indirectly by selling what proved to be mispriced bond insurance, enabling more bonds to receive faux triple-A ratings. As the bond insurers were downgraded in 2007 and 2008, this led to a massive wave of downgrades in the municipal and structured finance markets.

Interestingly, during the Great Depression, the insurance industry came under stress but insolvencies were idiosyncratic in nature, and the industry did not get swept up in the systemic wave of 9,000 bank failures. The one exception (not surprisingly) was the financial guaranty sector.

Insurance companies have limited exposure to systemic risk for several reasons. First, insurance companies are not subject to runs by depositors and policyholders in the same way banks are. Policyholder cancellations are more
The key point, however, is that these failures did not cascade to other solvent insurers or financial institutions. Indeed, this episode led the National Association of Insurance Commissioners to develop its risk-based capital standards, and to make it more difficult for insurance companies to build up concentrated exposures in real estate and lower quality assets. Those rules surely helped insurers avoid taking on significant subprime mortgage exposures and highly leveraged synthetic collateralised debt obligations in the run-up to the financial crisis. In short, any effort to gauge systemic risk exposure for insurance companies must come from looking forward to possible risks rather than relying on past experience.

Perhaps the biggest potential source of systemic risk is a catastrophic pandemic or natural disaster that exceeds any reasonable actuarial projection and affects a broad swath of insurers. This could lead to large-scale asset sales in a short period of time, possibly at fire sale prices. But this risk is if anything more likely to emanate from smaller non-SIFI insurers. Trying to limit this risk at diversified SIFI insurers may not reduce systemic risk exposure substantially.

A second source of risk is non-traditional insurance products that involve financial market risk, including variable annuities (with a guaranteed return feature), and more generally separate account asset management products. If the insurance industry continues to diversify away from traditional insurance products towards these, the potential for systemic risk exposure will also shift. A third source, ironically, is the SIFI designation. There is a perception that SIFI insurers could be perceived as too big to fail, which will lead to a variety of hard-to-measure but real externalities and risks for the industry and economy.

A fourth source of systemic risk is a flawed regulatory process. Systemic risk is a complex issue and there is a danger that regulators sidestep some of the problems and fall back on what amounts to form over substance regulation, thereby fostering a false sense of security. It is worth recalling that AIG’s Financial Products Division was overseen by the Office of Thrift Supervision; and that the London Whale episode at JP Morgan in 2012 occurred despite all the statutory authority conveyed to regulators by the Dodd-Frank Act. Some would say the imposition of banking-style requirements on insurers is a warning that the regulatory process is as much about satisfying certain political stakeholders as it is about trying to address a real problem.

The best an observer can do is hope for a measured but open and vigorous process. If the Fed ends up trying to impose stiffer requirements on traditional insurance businesses, the industry will be right to insist that the burden of proof lies with the Fed to justify its position. And if the Fed imposes bank-type capital requirements on financial risks that are clearly bank-like and the industry objects, the burden of proof should be on the industry to show why actuarial and risk management processes in insurance are sufficiently robust to protect the company and broader markets.

1 The Financial Stability Board is an international organization set up in 2009 to monitor financial market conditions and coordinate regulation and policy making globally. It has identified nine insurers globally as systemically important. The Financial Stability Oversight Council has designated American International Group, MetLife Inc. and Prudential Financial Inc. as systemically important financial institutions.
3 Hartford Financial received $3.4 bn and Lincoln National received $950 million.
4 These include Executive Life Insurance Co., Mutual Benefit Life Insurance Co., and Confederation Life Insurance Co.
It looked like the regulatory storm hitting banks in the aftermath of the financial crisis was about to come to an end. Not quite yet. In November 2014, the Financial Stability Board published a proposal on Total Loss-Absorbing Capacity to ensure that bank losses are absorbed by private investors without recourse to public support. So what is TLAC and what are the implications of its introduction?

The idea of TLAC was born because while the bail-in (as opposed to bail-out) of bank creditors has become a standard policy tool at the subordinated portion of the capital structure, it has still been problematic at the senior unsecured level. The reason is that senior unsecured bonds rank pari passu with systemically important liabilities such as insured deposits or derivatives. As a result, there remains a lingering worry about contagion to other parts of the financial system via funding markets and counterparty exposures. TLAC is supposed to dispel such fears by requiring that there be a sufficient amount of bonds subordinated to systemic liabilities.

The FSB proposal requires that global systemically important banks have a minimum of 16-20 per cent of risk-weighted assets or twice the leverage ratio requirement, whichever is greater, of TLAC-eligible liabilities. This excludes additional buffers required by Basel 3 capital regulations which if included raise the TLAC requirement to 19.5 to 27.5 per cent of risk-weighted assets. On top of that, additional firm-specific add-ons can be required by the authorities. This level of bail-in eligible liabilities should ensure that even the worst historical losses can be absorbed by private investors, ending the effective subordination of taxpayers to bank creditors.

In short, the threat of bail-in to investors is real. As a result, TLAC should lead to repricing of senior unsecured bonds by substantially reducing their implicit government subsidy. In particular, credit spreads of TLAC-eligible bonds should be wider than those of their TLAC-ineligible counterparts. We estimate that if the current implicit government subsidy in terms of senior unsecured credit spreads is 40 basis points, which roughly corresponds to IMF estimates, it should translate to about a 50 basis point spread differential between the two types of bonds.

There are three principal ways to subordinate senior unsecured bonds to systemic liabilities – statutory, contractual and structural. Statutory subordination would be achieved by legal rewriting of the creditor.
hierarchy in insolvency. Contractual subordination simply means that the relevant debt contract defines its rank below that of systemic liabilities. Structural subordination is achieved by issuing senior unsecured debt out of a non-operating holding company and then down-streaming the funds to operating subsidiaries via intra-group loans that would be automatically written down or converted to equity if a subsidiary gets into trouble. This allows loss absorption by bailing in holding company investors without the need to put the subsidiary bank, in which deposits and other systemic liabilities sit, through a disruptive resolution.

Not all banking groups have a holding company structure, however. While it is common in the US, UK, Switzerland or Japan, continental European banking groups typically have an operating parent company at the top of the corporate structure. Since there are substantial legal and financial obstacles to setting up a holding company, the options left are either statutory subordination or issuing a new type of “senior subordinated” debt. Most recently, the German government has taken a lead in proposing statutory subordination to achieve TLAC compliance. This would mean that all senior unsecured bonds would effectively become “senior subordinated” without having that label, which should be irrelevant in a rational world but is likely to be positive for bank funding costs in the real world. This pragmatic solution could become a blueprint for other European countries where banking groups do not have a holding structure even though it remains subject to the risk of potential legal challenges from bondholders claiming to have been retroactively subordinated.

Meanwhile, TLAC penalises retail banks that tend to have relatively higher risk-weighted assets and fund their loan books with deposits. The prospective rules have already led some retail-oriented banks to increase their target loans-to-deposit ratios in order to “make room” for potentially more volatile wholesale funding. Such a move represents a partial reversal of the post-crisis tendency to reduce reliance on wholesale funding and increase deposit funding. Also, US banks have traditionally issued senior bonds out of holding companies and many of them have TLAC in excess of the proposed requirements. There have been reports that some might now, paradoxically, move some of their issuance to operating companies which would cut funding costs by increasing their implicit government subsidy.

In terms of relative pricing across the capital structure, TLAC means there will no longer be a cliff between (TLAC-eligible) senior unsecured and subordinated bank bonds. Past bank failures typically involved a heavy haircut or total write-down being imposed on subordinated bonds in order to maximise recapitalisation while senior bonds were protected to minimise contagion. In the future, losses will walk up the capital structure regardless of seniority boundaries until satisfactory private recapitalisation has been completed. This should lead to some narrowing of the difference between senior and subordinated bond spreads.

Referring to the post-crisis regulatory overhaul, the Secretary General of the Basel Committee has recently declared that “there is light at the end of the tunnel, the big pieces are there and it’s really now about getting to the finish line.” Should this mixed metaphor be even half-true, the reduction of regulatory uncertainty would be a welcome growth stimulus.


For more details, please see our report “Pricing TLAC Rules into Bank Capital Structure” on gm.db.com.
Financial markets have a fascination with boundaries, especially when they are arbitrarily imposed. A good example is the boundary that separates investment grade (good quality) from speculative grade or high yield (poorer quality) amongst sovereign and corporate credits. Crossing the boundary between investment grade and high yield is often life-changing for issuers. Indeed, investment grade portfolio managers typically run mandates that prohibit exposure to speculative grade credits. When investment grade credits fall into the speculative grade category, the managers can become forced sellers. Worse yet, they would be selling into a high yield universe which is much smaller than the investment grade market. This can cause significant pressure on prices, particularly if a large amount of paper has to be absorbed, as well as lead to a significant increase in the issuer’s funding costs.

While mandate restrictions help explain why downgrades from investment grade to high yield can be traumatic, it is difficult to see why this should be so from a value perspective. The market is structured to take a binary view. It is as if the sun shines for investment grade credits and just a few yards away it is raining cats and dogs in high-yield land. Our analysis shows that these institutionalised distortions are in fact a source of value. To exploit these distortions we focus on fallen angels – credits that were formerly rated investment grade and have been downgraded to high yield.

To highlight the extent of distortions the investment grade/high yield boundary brings about, consider the following two investments: a $100 investment as of January 2000 in the DBIQ USD High Yield Bond Index¹ and a similar investment in a fallen angels portfolio constituted from the same index. The high yield

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Kunal Thakkar

¹ DBIQ USD High Yield Bond Index

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bond index is composed of corporate bonds with a minimum notional amount outstanding of $100m, issued in dollars across major countries and jurisdictions with the bulk of exposure coming from the United States. The fallen angels portfolio consists of bonds of companies in the dollar high yield bond index that have been downgraded from investment grade to speculative grade.

A $100 investment in the fallen angels portfolio between January 2000 and January 2015 would have grown to $420. That is nearly 50 per cent more than the $283 from an equivalent investment in the high yield index. How could this possibly be? After all, fallen angels are part of the high yield bond index too. What is the magic that separates fallen angels from other high yield credits?

The outperformance of the fallen angels portfolio over the high yield bond index is remarkable, not just because of the nearly 50 per cent cumulative outperformance, but because the portfolio dominates the index for both positive and negative returns. In other words, the portfolio produces higher returns than the index when returns are positive and it produces less negative returns when these are negative. This asymmetric behaviour, akin to being long options to the upside and downside for free is extraordinary. Could it truly be that investing in fallen angels is an all-weather winning strategy when benchmarked against the high yield bond index?

Sceptical readers may point to liquidity, which we completely ignore, as a key driver of performance of the portfolio relative to the index. There are two aspects of liquidity. The first is transaction costs. These are far from negligible for speculative grade names in most circumstances. However, they apply both to portfolio and index, so ignoring these does not skew results in favour of the portfolio.

The second aspect of liquidity is the fact that portfolio managers may not be able to buy every single fallen angel to replicate the strategy presented here. To address this concern, we only allow bonds with an outstanding of at least $250m into the fallen angels portfolio and then repeat the exercise again with minimum $500m outstanding.

At a $250m notional outstanding floor, the portfolio tracks the unconstrained fallen angels portfolio very closely suggesting there is no apparent cost to liquidity. At a threshold of $500m, the portfolio becomes idiosyncratic as fewer issues are eligible. It is difficult to draw definitive conclusions on this portfolio other than to suggest that small changes in underlying assumptions cause material changes in performance. The most general point that can be made regarding this portfolio is that it appears to be a turbocharged fallen angels strategy – a strategy with even more upside but also more downside than the original one.

Credit experts may also point to some exceptional circumstances that have contributed to the results presented thus far. For example, they may point to the experience of, say, Ford, General Motors and GMAC/Ally Financial as skewing our results to the upside. It turns out that these three credits are not material to the performance of the fallen angels portfolio but they are critical to the extraordinary option-like behaviour of the portfolio relative to the index.

It is our view that this option-like behaviour is due in part to the market disruptive events surrounding investment grade downgrades to high yield; on average, the market applies too much pressure on prices of fallen angels as they cross the boundary. This is particularly pronounced in the case of large issuer downgrades, given the flood of fallen angel debt it creates. It is also likely that the deeper the downgrade, the larger the opportunity to buy these on the cheap – again, on average.

Combining these sceptic and credit expert opinions produces a less flattering outcome for the fallen angels portfolio than originally presented. The portfolio still outperforms the index but it does not do so in all circumstances. In essence, the market does not allow market participants to sit back, buy the most liquid fallen angels and expect them to outperform come what may. Exploiting the properties of
A fallen angels portfolio cannot be done by remote control. It requires work. The majority of fallen angels concentrate around the investment grade/high yield ratings boundary. Two thirds of fallen angels that were originally rated triple-B minus (the lowest rating for investment grade credits) fell to double-B plus (the highest rating for speculative grade credits). Unsurprisingly, double-B credits dominate by market value. Investors may be tempted to focus on double-B credits of the portfolio at the exclusion of the riskier credits down the rating spectrum. Doing so however comes at the expense of a performance give-up. Moreover, the option-like characteristics discussed earlier are non-existent for double-B credits. Investors looking for outperformance and option-like characteristics have no choice but to focus on single-B and triple-C credits.

Still, the basic investment thesis behind the performance of fallen angels remains intact. Why is this so? Other than the artificial barrier between investment grade and high yield that generates price distortions that are favourable to fallen angels, at least two other dynamics are at play. The first is size. Fallen angel companies tend to be of larger size than those in the high yield universe. We pointed earlier to the special case of Ford, General Motors and GMAC/Ally where size played a role. We also showed that focusing on fallen angels with large notional outstanding leads to significant historical outperformance. Larger issue size is generally associated with larger company size and large companies tend to weather crises better, hence their outperformance. The second is what we refer to as the elastic band effect. Many fallen angels have ambition to return to investment grade status and hence have stabilisers including credit-friendly policies to help in this regard. As these companies fall into high yield, these policies kick in, acting with greater strength the deeper a company falls – up to a point where the rating snaps back again.

So why not invest in fallen angels right now? Well, there are two problems. First, the existing market environment is favourable for credit ratings so a large number of fallen angels are being upgraded back to investment grade. This continuously shrinks the fallen angels universe. Second, as with most credit-bound investment strategies, carry is an issue. An investment in a fallen angels portfolio produces a lower spread (427 basis points) than an investment in the dollar high yield bond index (482 basis points)\(^3\), even though this may be justified by the difference in quality between the two. In an environment where ratings are being upgraded, why stick to the safer, lower yielding ones? This is a reach-for-yield environment where investors do not consider giving up higher carry today in exchange for potential benefits of a fallen angels portfolio in the future when the credit cycle picks up steam and defaults rise.

Which is precisely the reason we believe that the fallen angel dynamics which have delivered significant outperformance to date will also prevail when the next cycle comes around.

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1. We use the DBIQ USD High Yield Corporate Bond Index for the entire analysis and refer to it as the USD HY bond index thereafter.
2. For further details on index rules please see index.db.com
3. As of January 2015 month end
Who would ever have guessed the incredible hullabaloo surrounding China’s new Asian Infrastructure Investment Bank?

Only months ago members of the G7 were supposedly agreed not to participate without consensus. Then hell broke loose in March when the UK suddenly announced it was joining—in defiance of America, other allies and its own diplomats.

Peter Garber
An outraged US unusually chastised Britain publicly over “this trend of constant accommodation” of China, but nevertheless other western countries soon followed. For many this humiliation of Washington was a powerful symbol of an eastward move in power. Others went further. Former Treasury Secretary Larry Summers wrote: “This past month may be remembered as the moment the United States lost its role as the underwriter of the global economic system.”

Whoa there! Mr Summers may well be right, but it is also arguable that such a reaction to the AIIB is both surprising and unwarranted. It is surprising because the inexorable development of the Chinese economy and the geopolitics of the region make the birth of such an institution pretty much inevitable. Meanwhile, America’s response is unwarranted because the impact is likely to be far less pronounced than feared – the AIIB is small relative to similar lending bodies and barely a partial substitute for bilateral lending that would have likely proceeded anyway. This article will examine both of these arguments in turn.

So why was it inevitable that a Chinese-led multilateral bank would emerge to challenge the existing Bretton Woods institutions? To answer this question the AIIB should be viewed first against the backdrop of the classic problems of international capital movements and the evolution of solutions to them [see box on page 28 for more details]. For at least fifteen years China’s development strategy has been based on net capital outflows and undervalued exchange rates to export the surplus capacity of its labour force. And with global real interest rates consequently driven to zero, the world’s industrial economies have been the principal destination for this surplus, converted into the form of manufactured goods.

The last financial crisis, though, impeded the ability of industrial countries to absorb ever-larger Chinese surpluses. In response, China shifted even more of its still-growing savings into vast internal infrastructure and property investment, while maintaining its absolute level of real net exports. With slowing internal growth, however, China has now reached the point of massive excess capacity in its construction and materials industries. Meanwhile, there is a need for $8tn of infrastructure investment in poor Asian countries, according to the Asian Development Bank – assuming a level of infrastructure in line with middle-income countries. Such capital famine seems a natural match for the export of the Chinese construction industry’s excess capacity.

This has been the case for a while, though. Hence for the past decade China has participated bilaterally in large construction projects, financed either directly by Beijing or by government-owned corporations with the blessing of the relevant ministry. So why not simply continue with these direct outlets of capital rather than setting up new and more controversial institutions
such as the AIIB?
The likely answer is that a multilateral bank may help overcome governance problems. These generally occur for three reasons. First, much of China’s lending has been directed at resource development investments in order to supply the country’s huge appetite for raw materials. These projects can involve some degree of corruption and lack of regard for the environment or local sensitivities – consistent with the way similar massive projects have been undertaken in China. Second, China has invested capital piecemeal into unstable countries, often with unfavourable outcomes. Third, such bilateral projects have a record of stirring resentment in many places. A rising resistance to such loans indicates this approach may have reached its limits.

In fact it is indicative that within China itself there has been a serious policy shift towards more environment friendly development. A strict anti-corruption campaign is also underway. Imposing such standards on foreign lending may be cut from similar cloth. A new multilateral bank with serious western involvement could help assure on lending standards while also keeping better discipline on loan and project performance. In addition western participation may make the flow of capital via the AIIB more acceptable to recipients, because somewhat more disinterested lenders may be vetting projects. That means low-quality projects are less likely to be initiated and those that do go ahead should do so with more objectively chosen contractors and suppliers. Also, from a lending perspective, there may be a lower probability of default on loans from a multilateral with widespread international participation.

If the classical path of economic development is the first reason why the birth of the AIIB should have been seen as less of a surprise than it was, the second is geopolitics. For the reality is that a geopolitical contest is growing in east Asia. From China’s perspective, friction with America has existed at least since 1996, when the Clinton administration sent two aircraft carrier battle groups to the Taiwan Straits as a demonstration against intimidating missile tests. This spurred China’s ongoing naval construction programme. More recent conflicts over islands in the South and East China Seas as well as US support for its allies in the area also rankles China.

No wonder, therefore, that the Obama administration’s pivot to Asia, although amounting to little, reinforced the idea the US is trying to block the rise of China. No wonder, too, that the futile US negativity on the AIIB can be interpreted as yet another part of this strategy.

Moreover, the accelerating US tendency to employ financial weapons against adversaries and even friends is a warning to China of how dangerous a dependency on the American global financial system can be. That surely helps explain why both current and potential targets for US sanctions, for example, are exploring
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the possibility of constructing alternative systems where they are less vulnerable to attack. Transferring assets out of the US in the form of claims on a multilateral lender protected by the membership of many countries can be interpreted as one response.

Likewise, moving away from the dollar by promoting the renminbi as an alternative is another response. To gain operational experience, China could be seen to be setting up experimental financial institutions to mimic the role of those institutions vital to the US monetary hegemony. Suddenly, for example, out pops an IMF-like institution in the form of the Contingent Reserve Arrangement, the BRICS mini-monetary fund. This is in addition to the already formed AMRO multilateral currency swap arrangement (ASEAN+3 Macroeconomic Research Office), which emerged from the Chiang Mai initiative and where Japan and China have equal weight. Other World Bank-like institutions, in the form of the AIIB and the New Development Bank (BRICS), both of which will be based in Shanghai, have also sprung into existence.

By successfully operating such institutions, China can demonstrate to the world it can supply a smoothly-functioning monetary bloc in a disinterested manner. Then, it can position the renminbi as a serious rival to the dollar at the heart of the global financial system. While relatively small for now, these are important developments. And seemingly out of fear of being marginalised in Asia, even the IMF and World Bank have expressed a positive attitude.

While the emergence of the AIIB can be explained using either economic or geopolitical reasons in isolation, these are often two sides of the same proverbial coin. In this case, once the possibility increased that access to the world’s resources and infrastructure was not secure, it is understandable that China wanted to hedge itself. Such worries in turn lead to a more of a bloc view of the world and the need to improve economic protection by securing both physical and financial markets, the latter by advancing the Chinese currency.

Economics and geopolitics are particularly closely bound in east Asia because all countries are essentially islands, dependent on secure shipping in the East and South China Seas and the Sea of Japan. This includes China – despite having a territory nearly continental in size – given its need to import raw materials and energy in bulk and to export manufactured goods, mostly by sea. China’s Communist Party leaders have no doubt read that the American submarine campaign against Japan during the War demonstrated how to cripple an industrial island economy. Lesson learnt. The geopolitical contest among east Asian countries is now expressed in a programme of submarine construction – an obvious choice to effect a sea-lane denial strategy.

As geopolitical insurance against the loss of sea transportation, China is also counterbalancing its island status by
shifting to inland transportation of commodities, especially energy. From this perspective, the Silk Road and Maritime Silk Road funds are geopolitical exercises that would obviate the worst effects of blocked sea transportation. These routes would open protected access to the raw materials of landlocked central Asia by building roads, railroads, pipelines and better-protected port outlets. The AIIB is yet another vehicle to open up these resources and to ensure closer integration with former Soviet central Asian republics, other landlocked Asian countries, and, via shortened sea-land routes, even the Persian Gulf.

It can now be seen that the fevered response to the AIIB was surprising given its inevitability. But the headlines produced by the US response, not to mention the likes of Mr Summers, were also unwarranted for the simple reason that the new institution is likely to have less impact than feared. That is due to the AIIB’s modest size and also because it represents more of a shift in the form of China’s large capital exports rather than an addition to them.

Of course the AIIB is in its formative stage and its eventual size and structure is unknown. So far China has only sent out invitations to negotiate the shape of the institution. It was announced that the prospective capital of the institution is $100bn and there is a vague acknowledgement that China will not have veto power. But China will provide half of the capital, with a quarter coming from other Asian countries and the rest from ex-Asia participants.

For comparison the equity of the World Bank’s International Bank for Reconstruction and Development (IBRD) balance sheet was $30bn midway through last year, of which $14bn was paid-in capital from its members and the rest retained earnings. In contrast, the IBRD’s subscribed capital is $235bn. To maintain its AAA rating, the IBRD maintains an equity-to-loan ratio of no less than 20 per cent. Therefore, its $360bn in assets comprised of about $150bn of loans, a similar amount in derivatives receivables and $50bn of securities investments. It also borrowed $160bn. The IBRD’s new lending commitments in 2014 were almost $20bn.

The Asian Development Bank is set up similarly. At the end of 2013, it had paid-in capital of about $8bn, subscribed capital of $160bn and retained earnings of $10bn. Its loans were $55bn out of total assets of $115bn and it borrowed $60bn. The ADB’s new lending commitments from its main accounts were about $10bn. Japan and America are the largest shareholders, with about 13 per cent of the vote each (the president has always been Japanese).

Although the meaning of the headline $100bn of AIIB subscribed capital is not yet clear, suppose that subscribed capital and paid-in capital are in proportion to the ADB’s. In that case the AIIB would have a balance sheet capital of just $5bn. And if it behaved as prudently as the ADB, its loans would peak at around
$35bn with borrowings at about the same level. As the AIIB filled out its balance sheet, the capacity for new lending would initially equal the ADB's but then fall off.

It is worth noting here that the new Brics Bank will have about $50bn of initial subscribed capital rising ultimately to $100bn authorised. Total initial paid-in capital will be $10bn, delivered over seven years. Lending will not exceed the amount of subscribed capital and surplus, so it will not lend more than a total of $50bn in the medium term but probably much less. So to the extent that they are rivals, both the AIIB and the Brics Bank seem to be more in competition with the ADB than with the World Bank.

Therefore the AIIB is a long way from a threat to existing Bretton Woods institutions in terms of size, at least as things stand currently. However another reason the US overreaction was unwarranted is because the AIIB represents more of a change in the shape of capital outflows than a significant addition to them. Indeed it is helpful to compare the magnitude of China’s participation in new development banks such as the AIIB and Silk Road Fund to the other outlets for its capital exports currently.

Foremost of these has been the acquisition of foreign exchange reserves, which amounted to almost $4tn at the end of last year. China’s accumulated current account surplus since 2000 is $2.5tn and the country is expecting to export another $220bn of net capital this year. Indeed, outward direct investment had cumulated to $610bn by the end of 2013, with over $100bn added in 2014 alone. ODI is often used for resource and transportation development to supply China’s need for raw materials and these numbers dwarf anything these new multilateral lenders are hoping to invest.

Another way of thinking about this is that given inward foreign direct investment from 2000-2014 was about $2.5tn, China’s financial strategy in effect involves exchanging its equity for low yielding fixed income claims on the rest of the world. But even so the new financial institutions together are relatively small currents in China’s vast pool of capital exports and will likely mainly substitute for the less successful piecemeal bilateral projects of the past.

Finally it is worth asking: if the creation of the AIIB should neither be thought of as surprising or directly impactful is there nothing to worry about at all? Two potential flashpoints are worth looking out for over the coming months and years. The first concerns Chinese dominance of the AIIB and fears about lending quality and governance. The second involves India.

Despite China having less control over loan contracts than it currently does, AIIB projects would likely still employ Chinese builders. That is because over the last decade China has been by far the largest builder of infrastructure in the world, leading to an
immense capacity to produce steel and concrete. With this excess capacity, China is likely to be the legitimate low bidder on most projects in the region, facing some competition only from Korea or Japan. In addition, unlike the IMF or World Bank, it seems that the AIIB’s executive directors will not be in residence, so the primarily Chinese staff will have much more power.

So even if the awarding of contracts via the AIIB is based on objective standards and competitive bidding, Chinese contractors will probably walk away with the lion’s share. Although western countries with a commercial motive have signed up for a piece of the action, their contributions may be limited to the provision of some design and machinery. And with some of the ideological fire removed by America’s absence, this mercantile streak may also soften the AIIB’s aversion to projects of lesser quality.

In addition, China will still face the same problems of placing capital in poor countries as always, even with this new institutionalisation of capital exports. So far China has managed to export capital to problematic sovereign states by ignoring the ideological concerns about, say, the environment and corruption, that have handcuffed the existing multilaterals. Inevitably though, China’s excess capacity and pressing need to export via decentralised corporations have delivered problematic loans. The AIIB should curb such lending, but the end of China’s own infrastructure binge is leaving such enormous excess capacity that the need to export capital is larger than ever. The pressure to waiver or relax standards will be immense.

The second issue to watch out for is a growing tension with India. That is because those most in need of the AIIB’s infrastructure investment are very low wage countries. These economies have not seriously competed with China in low wage manufacturing because of problematic transportation and energy infrastructure, security, and incompatible cultural and vested interests.

But now the Modi government plans to become the next giant in the Bretton Woods II system by developing a manufacturing-for-export sector and opening the door to foreign direct investment. This should make India the most attractive destination for infrastructure investment from China, and hence the AIIB. However, does China really want to launch India as a major competitor in the exportation of cheap manufacturing labour? China’s export gains from managing infrastructure construction risk will be offset by lost exports in manufacturing as it undercuts its own unskilled labour and opens a channel that directs western investment, technology and management elsewhere.

With luck, neither flashpoint will materialise. While the reaction to the AIIB’s birth was both a surprise and unwarranted, the best way the bank can defy its critics is to grow into a mature, respected and rational part of the global financial architecture.
China’s accumulated current account surplus since 2000 is $2.5tn and the country is expecting to export another $220bn of net capital this year.
Unconstrained private capital pursues a higher rate of return when available abroad, so it will be exported to other sovereign territories if foreign protections are similar to domestic ones. Historically, this proviso was rarely met, so capital stayed near home until even recently, as indicated by the famous Feldstein-Horioka puzzle of 1980. There have been only two periods of large-scale international capital flows among sovereign states: the few decades prior to 1914 and after the end of the Cold War. The explanation is simple: one could rarely trust that the local sovereign would not steal one’s property. The US was a notable exception to this, perhaps as a result of the principles of financial soundness laid out by Alexander Hamilton. In 1814, the US Treasury Secretary was concerned that his inability to get bills of credit through the tight British naval blockade to pay interest due on the Mississippi purchase bonds to creditors in London would harm the country’s creditworthiness. Adherence to such principles under trying circumstances no doubt built trust and meant that for the next century the US received the massive British capital exports that turned it into a superpower. One can see why Argentina is so distressed today in a similar situation!

In the absence of sufficient innovation and population growth, both neo-classical and Marxist growth models predict that a growing economy eventually will generate so much productive capacity that returns to capital will plummet and those employed in capital goods industries will have to be redeployed. But as an alternative outlet, capital can be exported, which also boosts demand for the otherwise redundant industrial labour.

One need not be a strict Leninist to agree that imperialism and the acquisition and development of colonies rich in raw materials was a temporary solution to these combined problems. But even in a colonial context, lending into a poor, traditional country is disruptive of local economic arrangements, and property rights may be ill-defined. So it was a natural feature of capital export to bribe local elites to protect investor rights. Principally, projects in exportable natural resources and raw materials or transportation infrastructure to ports would generate the direct payoff needed to justify the investment, so these were made with little regard to local interests: environmental issues, local property rights, population displacements, and internal development. The ability to ignore such issues shifted the marginal efficiency of the investment curve outward from the foreign investors’ perspective,
thereby making many otherwise marginal projects viable.

That the scramble to corral the resources necessary to develop economically and to survive a total war itself led to total war was the lesson absorbed from the world wars. The UK and US planners of the post-war system thought it necessary to produce the good Nash equilibrium in which all major powers believed that they would have equal access to the world’s resources.

As part of their rationale, the multilateral lending institutions provided one of the means to this end. During and after the second world war, pervasive controls prevented private international capital flows, so it was natural to establish official lending institutions to channel lending from the capital rich countries for reconstruction and development. As a multilateral institution, the World Bank could channel capital from all countries into projects that all member countries could scrutinise and compete for. Hence, in theory, all could compete equally for the loan repayments and the project’s product without warping capital flows through closed blocs.

In practice, the post-war world was quickly transformed into exactly those closed economic blocs that the multilaterals were designed to avoid. Residual colonial relationships persisted but the collapse of colonialism in the 1960s loosened intra-empire favouritism on capital flows at least within the Western bloc. Ironically, the World Bank and its sister institutions faced problems similar to those of the old colonial investors. Their mandate was to book loans, so problems of corruption, environmental degradation, and property rights violations were far down the list of considerations. Also, the exigencies of the Cold War caused geopolitical considerations to affect their decisions and thus loans were made to corrupt and oppressive but strategically important regimes but and withheld from unfriendly countries.

Nevertheless, loans for internal development in less developed countries were a major part of their portfolios. Coincident with the end of the Cold War, a new ideology emerged to consider environmental impact, corruption, and other issues more seriously in the loan approval process. This had the ironic effect of pushing the marginal efficiency of investment curve inward, eliminating many infrastructure projects from the viable list either because they did not meet the new standards or because local elites would not deliver in the face of disruptions to their own power (in the absence of some grease to the wheels). Eventually, though, the flood of private sector lending to emerging market countries after the Cold War and lack of commensurate growth in their own balance sheets made the multilaterals less relevant.
Indian e-commerce—China 2.0?
When the mobile phone was invented in 1973, it was the size of a small dog and had the battery life similar to a canine attention span. Nevertheless it was clear that the technology was going to transform the telecoms industry. Less obvious was the eventual impact on other parts of life, in particular retail. In 2007, Apple’s iPhone not only made mobile e-commerce a thing, it caused businesses to change the way they operate. In the US today, one-third of all smartphone users shop online with their device. Ditto for one-quarter of British and Australian users. In tech-savvy South Korea, the proportion is even higher at 40 per cent.
Throughout history, there are few examples of poor countries adopting a technology quicker than rich ones but mobile e-commerce may be one such exception. In China, about 40 per cent of smartphone users make online purchases with their device, a rate well ahead of most of the world’s rich and powerful countries. And in many African countries, mobile internet allows access to banking and other retail products, particularly in regions where physical infrastructure is a problem.

That is surely a palpitating thought for India. Its status as the world’s other billion-person country usually leaves it as the loser in the comparison game with China – sometimes rightly, sometimes wrongly. Perhaps the telling fact is that in the late 1970s, output per capita in the two countries was about the same. Today, the average Chinese produces about two and a half times the output of the average Indian.

Given the divergence of fortunes, many comparisons between the two countries are not relevant. At first glance, this appears to apply to the mobile e-commerce market too. First, the entire e-commerce market in India is only about three per cent the size of China’s. Second, Indians who own smartphones simply do not use them to buy stuff – only seven per cent compared with over 40 per cent in China (and 17 per cent in fellow BRIC countries Brazil and Russia).

On closer inspection, though, comparisons with China may be more relevant than they first appear. Breaking it down to first principles, e-commerce allows a business to sell products without a traditional physical presence. At the other end of the transaction, a smart phone allows a customer to buy things without a (relatively expensive) PC and wired internet connection. Both sides save on costs and time. Research shows that transactions on a mobile device are completed quicker than on a desktop computer. Perhaps more importantly, the mobile aspect allows a transaction to take place with a reduced reliance on the government to build out traditional infrastructure.

The growth in Chinese mobile e-commerce has been partly due to this – the relative lack of infrastructure, particularly in rural areas. When viewed in this light, comparisons with China highlight even greater potential in India. Here are a few quick comparisons. More than two-thirds of Indians (across all age groups) live in rural areas compared with less than half of Chinese. And while across the population, internet penetration is just 15 per cent, one-third the level of China, over the last five years it has grown at a compound rate of about 25 per cent, two and a half times the Chinese rate.

India also has a very young online population. A full three-quarters of mobile internet users are under-35 compared with 60 per cent in China. And although the proportion of Indians who buy things on their mobile is very small, this is probably due to the lack
of internet-enabled businesses. Indeed, formal or organised retail in India accounts for just five per cent of total retail sales, one-quarter the figure in China (and compared with 85 per cent in the US). Given that formal businesses tend to be more efficient and have a better growth profile over the long term, the increasing pool of online mobile customers will almost certainly spur businesses into e-action.

Demand from Indian customers certainly appears primed for mobile e-commerce. The country already has the world’s third highest number of internet users and the people who plug themselves in are increasingly mobile – 60 per cent currently access the internet on the go and the proliferation of smart phones should grow at a compound rate of almost 40 per cent over the next three years. With the technology now in their hands, demand pull should pressure businesses who will, in turn, seek the mobile digital rewards. All that sets up Indians to leapfrog the need to first use a desktop and wired internet connection before going mobile.

Nor are the hurdles for new online businesses as high as they seem in India. First the big one: changing customer attitudes. Only seven per cent of Indian mobile users buy stuff on their phone. The most common reason cited – a lack of trust – is common to almost any new e-commerce market. But trust comes with experience. In China, research shows that people who shop online start with inexpensive products, such as clothing, and then progress to more expensive items.

Already there are signs that online purchasing is becoming more accepted in India. In the five years to 2013, e-commerce transactions grew at a compound rate of 35 per cent, led by the travel industry. As people become more familiar with basic internet purchases such as this, others will follow. Again, look at China. Even though the mobile e-commerce industry is less than a decade old, almost two-thirds of Chinese people who have smartphones say they now rely on their device when making any shopping decision and, unsurprisingly, the number one reason why most Chinese go online when shopping is to compare prices.

The next hurdle is how to pay for online purchases. Here, the issue is the tiny number of credit cards that exist in India – just 20m, or one for every 60 or so people. Online wallets and the greater acceptance of debit cards could improve the situation and inevitably, in a market where willing buyers and sellers both exist, online businesses will find a way to enable payment.

Finally, there are tax and regulation hurdles. Current taxes on goods moved between states increases logistical costs, however, the planned introduction of a national Goods and Services Tax next year should reduce this burden. Restrictions on foreign direct investment into the customer-facing multi-brand retail sector, however, are more challenging. Essentially, these rules protect the plethora of informal or small-formal retail operators
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India has been “the next big thing” for decades but has never fully delivered on its economic promise. So when it comes to mobile e-commerce, a degree of conservatism is warranted. But it is encouraging to note that a fundamental platform for the industry already exists and many indicators suggest the potential is greater than in China.
spread across the country but they are not as exclusive as they may seem. Amazon and eBay have both sunk their teeth into India as operators of marketplaces and Amazon is able to offer customers its “Fulfilled by Amazon” services and arrange partnerships with local businesses.

Of course, it is wise to question why all this potential has not yet been exploited. After all, India has been “the next big thing” for decades but has never fully delivered on its economic promise. So when it comes to mobile e-commerce, a degree of conservatism is warranted. But it is encouraging to note that a fundamental platform for the industry already exists and many indicators suggest the potential is greater than in China. Indeed, the biggest hurdle to growth in the Indian mobile e-commerce market is the supply of e-enabled businesses, and customer acceptance. The former should naturally grow on the back of the spread of smartphones. The latter should evolve as a consequence. In that respect, the infancy of the Indian market looks little different to that of China’s at the same age. After spending decades being labelled the less-successful billion-person country, mobile e-commerce may be one way India can begin to catch up.
China’s march to financial market freedom
It’s finally happening. China has started to see meaningful capital outflows, its central bank is having to draw down reserves to support the currency but the renmimbi is weakening nevertheless. This is a far cry from the late 1970s before China began to open up. Back then, the government had complete control over interest rates and there were no debt and equity markets. Even trade in goods and services was heavily restricted. That all changed after Deng Xiaoping became leader in 1978. He soon liberalised the economy, most notably the product markets, where prices rather than quotas would determine supply and demand.
Today, things seem to be happening so quickly that it is worth recapping how China has arrived at a point of almost-free financial markets. One irony is that Beijing had always intended to liberalise interest rates, but this goal always seemed to recede into the future. That was because the financial sector was increasingly viewed as one of the key levers by which the government could exert control over the economy. The scarcity of capital resources and the lack of financial market infrastructure helped in this regard. For example, in the late 1970s around three-quarters of state-owned enterprise financing came directly from the government. By 1986 this had fallen to 30 per cent, with commercial and rural banks replacing the state in terms of financing. But non-bank financial institutions also came into existence such as urban credit co-operatives and trust companies.

Also around this time, foreign currency obtained through imports and exports was allowed to be partially retained. This resulted in the creation of a dual currency market – the official foreign exchange rate and the market rate. But then followed a period where more significant reforms were frozen as inflation skyrocketed in the mid-1980s.

After this break the liberalisation of financial markets accelerated again in the 1990s. For example, the Shanghai and Shenzhen stock exchanges were created in 1990 and 1991. Banks started to move their liquidity to these and other exchanges, which raised concerns that asset bubbles would form. Indeed, over this period non-performing loans did start to grow. The government realised this was happening and started to reduce the pressure on banks to direct lending to favoured projects. But this simply led to banks devolving lending to the local government level.

Then the Asian crisis in 1997 caused non-performing loans to rise dramatically, though thanks to tight capital controls China’s currency markets were unscathed. Nevertheless, bank balance sheets had to be cleaned up. Lenders were re-capitalised and asset management companies were set up to manage bad loans. Importantly, an interbank market was set up, and bank exchanges were shut.

The period from the 2000s onwards has been the most interesting period for financial market liberalisation. Essentially China was becoming too large and complex to have so many controls in place in the banking and external sectors. Often these controls were having unintended consequences. For example, the ceiling on lending rates was preventing small and medium-sized enterprises from receiving loans. This ceiling was eased in the early 2000s. Meanwhile, ever more capital was attempting to get into China. Foreign direct investment was possible, but portfolio flows were heavily restricted. In 2002, the qualified foreign institutional investor (QFII) quota was set up, which allowed a certain amount of foreign capital to flow into Chinese equity and debt markets. But foreign direct investment still dominates with around $250bn in
annual flows compared with $60bn of portfolio inflows. With China becoming such a large international player it was natural that Beijing wanted to internationalise the renminbi too. To experiment with renminbi convertibility, China began to develop an offshore renminbi market in 2004, with the Chinese and Hong Kong governments allowing Hong Kong residents to convert a daily limit of 20,000 renminbi. Then, in 2007, the People’s Bank of China allowed banks to issue renminbi bonds in Hong Kong.

The offshore renminbi market has seen substantial development since July 2010. Renminbi cross border trade and investment settlement flows have been more or less liberalised [see box at the end of this article for the projected path to full convertibility]. With the strong growth of offshore renminbi liquidity relative to the offshore renminbi asset pool, investment programmes were created to allow some of this money to flow back into China. Direct access to the interbank bond market, the renminbi qualified foreign institutional investor scheme and, most recently, Hong Kong-Shanghai Stock Connect are all examples of such programmes. Additionally, mainland renminbi deposits were made available to Hong Kong and Taiwanese residents. Today there is about CNY2.5tn of offshore renminbi deposits in eight offshore renminbi centres, 60 per cent of which are in Hong Kong.

However, these new initiatives have not always been enough to capture all the demand for cross-border flows, especially given the much higher interest rates in China than most developed world. That spread, between the offshore and onshore renminbi interest rates, encouraged funding arbitrage as well as carry trade opportunities—for instance, borrowing in the offshore renminbi market cheaply to be invested in the onshore market. Indeed, given the heavily managed currency, the volatility-adjusted carry at various times has been the most attractive in the world.

Markets were also quick to take advantage of the opportunity posed by a fully liberalised current account amidst a relatively closed capital account, and began to disguise capital flows as trade flows. A common trick would typically involve exports to Hong Kong, such as integrated circuits, being marked at ten times their true value to allow more foreign currency (often dollars) to be converted to local currency on the mainland. The difference in interest rates between the US and China and the offshore/onshore renminbi pricing gap could then be captured.

As well as currency markets, bank lending rates have also been steadily liberalised, such that by July 2013 there were no floors left whatsoever. There have been limits, however, to how high deposit rates could go. The thinking was that banks (especially medium and smaller banks) would compete away their interest margins as deposit rates became flexible. What was not anticipated was the rise of wealth management products and e-commerce. Suddenly cash held in accounts to pay for goods on the largest e-commerce platform was paid more attractive rates than
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the interbank market. The largest such product is Alibaba’s Yu’e Bao, which has close to $100bn under management, which makes it the third or fourth largest money market fund in the world.

The upshot of all the above is that China today has a fairly open capital account. But with a current account likely to remain in surplus over the coming years, policymakers are likely to promote a further opening to encourage capital outflows as an effective way to achieve a balanced international position. Moreover, such capital outflows need not be viewed as capital flight but rather as a gradual process in which both Chinese corporations and individuals will increase their foreign assets for diversification and higher returns than could be achieved through the official foreign exchange reserves. For example, more Chinese corporations will pursue cross-border acquisitions to acquire technologies and resources as well as to access new markets. Likewise, the “One Belt One Road” initiative, the Silk Road Fund as well as the Asia Infrastructure Investment Bank all indicate that China will become a large net exporter of capital in the coming years both to support regional economic growth and absorb domestic excess capacity [see box on page 28 for details on this]. At the same time, foreign investors will have broader and freer access to the domestic capital markets.

This importance of two-way capital flows is understood by China’s authorities who last year widened the permissible fluctuations in the currency to plus or minus two per cent around the official rate set by the central bank. Of course no central bank can control both its currency and interest rates if there are no capital controls. With China keen to retain control of interest rates, that means its currency markets will be the most exposed to market forces. Given that credit in China has expanded rapidly, while property prices fall and economic growth slows, the currency markets will likely see the biggest volatility. Other risks such as a bank crisis along the lines of what was seen in the US in 2008 are less likely as the government is well-placed to underwrite the financial system. Therefore if there is one pressure valve for the transition in the Chinese economy it would be the currency markets – all eyes should therefore be on the renmimbi.

In conclusion, China has accelerated the pace of financial reforms since 2014 and is on the home stretch towards capital account convertibility. Introducing deposit insurance, fully liberalising deposit rates, increasing renmimbi flexibility, liberalising capital accounts and transitioning to a new monetary policy framework that targets both the short-term interest rate and money supply growth are key
reform initiatives in the coming one to two years. Renminbi convertibility is a necessary condition not only for inclusion in the IMF’s special drawing rights assets, but more importantly it is a critical step in China’s economic rebalancing by improving the efficiency of financial resource allocation. These challenges are great but not necessarily unconquerable until ultimately the renminbi assumes its place as a global reserve currency.
A convertible renminbi in 2015?
Zhiwei Zhang

The government sent strong signals in March that it aims to make the renminbi convertible for capital account transactions this year. Specifically, Premier Li Keqiang mentioned in his annual working report to the National People’s Congress on March 5 that “China will achieve renminbi convertibility under capital account”. This is a stronger statement than what he had said in a working report from 2014, namely that: “China will accelerate renminbi convertibility under capital account.” Meanwhile, Governor Zhou Xiaochuan of the People’s Bank of China also said explicitly in several conferences two months ago that the government aims to make the renminbi convertible in 2015.

These messages are important for investors. It means China will likely open its capital account significantly this year. To put this issue into perspective, there has been a long and intensive debate about whether China should liberalise its capital account and make the renminbi convertible. While the PBoC has been pushing this initiative for years, the reality is that many influential policy advisors have spoken openly against it. Two examples are Professor Justin Lin, former chief economist at the World Bank, and Dr Yu Yongding, former head of a research institute at the Chinese Academy of Social Sciences and former member of the monetary policy committee at the PBoC. One argument they repeatedly point out is that capital account liberalisation often leads to financial crises. Hence liberalisation has been slow in part due to these different views.

But the statements from Premier Li and Governor Zhou now suggest the debate within the policy circles has reached an end. A decision has been reached by the leadership and it will be implemented in 2015. Indeed, we have seen actions taken by the leaders last year to push for renminbi internationalisation. President Xi and Premier Li have often used their visits to other countries to promote the renminbi. For instance, after Premier Li’s visit to the UK in June last year, China’s currency started directly trading against sterling, with the UK government issuing renminbi-denominated bonds. Then in November President Xi visited Australia. That month, an official renminbi clearing bank opened in Sydney and a provincial government in Australia issued renminbi bonds.

So it seems that the Chinese government has decided to promote renminbi internationalisation as part of its strategy to
enhance its global influence [see our feature on the AIIB].

The next step is clear: Beijing will try to make the renminbi part of the currency basket for Special Drawing Rights. SDRs refer to supplementary foreign exchange reserve assets defined and maintained by the IMF. Their value is determined by a basket of major international currencies. Based on the latest review conducted in 2010, the current SDR basket consists of four currencies: the dollar (41.9 per cent), euro (37.4 per cent), pound sterling (11.3 per cent) and the yen (9.4 per cent).

To apply to become a SDR basket currency, the renminbi needs to be “freely usable”, a legal term that is subject to the judgment of the IMF. The renminbi has become convertible for current account transactions such as trade and tourism, but it has not become convertible for most capital account transactions (with the noticeable exception of foreign direct investment.) Hence, the IMF review of the SDR currency coming up this October works as a commitment device for the government to push for capital account liberalisation in 2015, which would strengthen the case of the renminbi to become an SDR currency.
India’s informal sector—unregulated, under-reported, thriving
India’s impressive growth record over the last two decades stands on a peculiar set of facts: less than three per cent of the population files for income tax (in the US the comparable figure is 45 per cent); after years of effort the indirect tax (sales tax and duties on everyday transactions, for instance) collection is under five per cent of output while India’s fiscal revenues at 20 per cent of output are well below other emerging market economies at 30 per cent.
This peculiarity needs to be understood in the context of India’s exceptionally large informal economy, operating outside the lens of formal observation, oversight, or analysis. Numerous businesses are unincorporated, transactions involving huge quantities proceed daily on a cash basis, most people and businesses do not file for taxes, making a sizeable chunk of the economy unregulated and unsupervised. The presence of a large informal sector leads to a number of incongruities: the government finds it hard to widen the tax net, ending up overburdening the formal sector; employees in the informal sector receive no protection or benefits (insurance, leave, and pension, for instance) under the law, and perhaps most maddening for the analyst community, it leaves considerable uncertainty about the size and performance of the actual economy.

India’s statistics commission suggests that half the gross national product is accounted for by the informal economy. Meanwhile, nine out of every ten workers in the country are engaged in the informal sector. The government’s statistical body, recognising that the informal sector is here to stay, carries out a periodic household survey to capture salient features of the sector. The latest version of this survey, published in January this year, finds that about a half of the workers surveyed are employed in the non-agricultural informal sector with the number rising to a whopping 90 per cent once workers in the agriculture sector are taken into account.

According to government surveys, over 90 per cent of the workers involved in agriculture, fishing, construction, and wholesale and retail trade are engaged informally, while the proportion of the same in manufacturing and transportation is over 80 per cent. Beyond agriculture production, those who are in the rural informal sector tend to be associated with agriculture services and small businesses, while those in the urban areas are mostly associated with services and small manufacturing.

Needless to say, virtually no one working in the informal sector has a job contract – although to be fair two-thirds of those in the formal sector also do not have a job contract. Less than one-quarter of the informal sector workers have leave provisions. Strikingly, 70 per cent of such workers receive no social security benefits either. While those directly involved in farming receive subsidised fertilizer and have the public sector as the purchaser of last resort for some food grains, those in the non-agricultural informal economy are largely left behind from social safety nets.

Yet the urban informal sector in particular exists side by side with India’s much observed formal economy. Katherine Boo’s unforgettable narrative nonfiction “Behind the Beautiful Forevers” follows the lives of a number of urban slum dwellers—Abdul the garbage sorter, Kalu the scrap metal thief, Asha the aspiring
politician. All these characters are part of the informal economy thriving in Mumbai’s makeshift settlements, providing goods and services for the entire economy, yet operating outside its purview.

However, the performance of this informal economy is impressive. Companies that specialise in selling to the rural sector report strong rises in income and purchasing power in rural India, which suggest a burgeoning informal economy. Improvement in roads, greater access to electricity and running water, and a remarkably sharp rise in access to mobile telephones have allowed informal sector workers to engage in higher value added activities in recent decades. For instance, as cooking fuels have become more easily available, those who spent inordinate amounts of time collecting firewood can now engage in more worthwhile activities. As workers focus less on subsistence and more on engaging in businesses of trading goods and services, they generate more activities and demand.

As the informal sector becomes more connected to the rest of India, many positive spillovers take place. A village getting road access sees its land prices soar, pushing up wealth and sense of well being among the villagers. As they get access to more modern products (processed foods, for example), aspiration for consuming a broader spectrum of goods rises. Large Indian consumer companies have caught on to this phenomenon, reporting considerably higher sales growth in rural areas in recent years relative to urban areas. The urban informal sector is replete with examples of migrant workers using it as a stepping stone toward building wealth, skills, and the experience needed to transition into the formal sector.

But the persistence of large scale informal sector activity has its costs. As pointed out earlier, India’s tax base is exceptionally narrow, limiting the role of the public sector in financing the goods, services, and infrastructure commensurate with the economy’s potential. Since many transactions take place outside the banking system, with many relying on money lenders to borrow and gold or real estate to save, the central bank’s monetary policy efficacy is considerably hampered. In recent years, efforts to tighten monetary policy were neutralised to a large extent as higher interest rates had no impact in curbing demand in the informal sector.

The prospect for informal sector businesses and workers is also limited. While they may thrive despite various constraints, the growth potential for such businesses is limited and informal sector workers receive virtually no protection under the law with respect to benefits or working conditions. The high volume of cash involved in construction, mining and real estate, creates
India’s statistics commission suggests that half the gross national product is accounted for by the informal economy.

Meanwhile, nine out of every ten workers in the country are engaged in the informal sector.
India’s informal sector—unregulated, under-reported, thriving

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a wide array of distortions and inefficiencies. Prices officially quoted for an apartment, for instance, are only a fraction of the real cost, allowing for tax evasion and perhaps even money laundering.

The Indian government has tried several approaches to bring the informal sector under the formal fold. Tax authorities in recent decades have handed out simplified procedures to file for taxes and register businesses, although the results have not been encouraging. Previously untaxed parts of the economy, especially in the services sector, have been brought into the tax net, but the fact that tax yield has not improved suggests room for improvement.

Some of these government policies are promising though. For example, the government in recent years has pushed banks to create accounts for the poor, who in turn are being provided with unique identification numbers with biometric verification. These accounts and the identification numbers can then be used to provide public sector benefits to those in the informal sector, and as the process takes hold, individuals become part of a record keeping and financial history trail. The expectation is that this will help those informal sector workers to establish a formal identity that can then be used to apply for credit, receive funds, make payments and so on. Also, once a record trail is in place, authorities would be able to track and monitor the cash transfers and well-being of the informal sector workforce. Similar incentives and programs can be provided to businesses, which will be given the carrot of reasonably priced and transparently administered credit in exchange for incorporation.

Informal sector activities will remain a key characteristic of the Indian economy for decades to come, but there is a good chance that more and more individuals and businesses will join the formal sector, lifting the economy’s revenue and growth generating potential.
India’s informal sector—unregulated, under-reported, thriving
Singapore after Lee Kuan Yew
Singapore’s iconic founder and first Prime Minister Lee Kuan Yew passed away in March, just a few months short of the city-state’s fiftieth anniversary. It was the passing of an era in more ways than one. Singapore has had an extraordinary journey as it evolved, in a little more than a generation, from a British imperial outpost into one of the most successful cities in the world. >
At each stage of this development, visionary political leadership was able to add a new layer to the economy as it moved up the value chain – from a naval outpost to a manufacturing cluster, then a financial center and more recently a hub for education, research and entertainment. Indeed, Singapore increasingly thinks of itself as Asia’s “global city”.

However, the city-state now has to face a different problem: how to maintain socio-cultural continuity in the face of rapid demographic change. The way Singapore manages this challenge will have a significant impact on its political and economic future.

Singapore’s population is currently estimated at 5.5m of which 3.3m are citizens and half a million permanent residents (together they are considered the resident population). The remaining 1.7m are foreigners. The problem is that the resident population has a very low fertility rate. Total fertility rate is defined as the average number of live births per woman over her lifetime. The city-state requires a TFR of 2.1 in order to keep its resident population stable, but the registered rate is just 1.2, a little more than half the “replacement rate”.

The government has long recognised the problem of low birth rates but, despite many efforts, nothing has so far succeeded in pushing up fertility. This is not a unique problem and is common to many countries in Europe and East Asia. One option is to accept demographic decline and allow the population to shrink (some other Asian countries seem to be opting for this). Singapore’s problem is that as a “global city” it requires a minimum cluster of activity. As it is, Singapore has the smallest population of any major global hub and there is a non-trivial risk that a steady decline in its population would trigger a process of de-clustering. Urban history shows that once de-clustering takes place, it can gather an unstoppable momentum that is difficult to arrest (ask Detroit).

The obvious implication is that Singapore will need to rely heavily on immigration. Note that the abysmally low TFR implies that the incumbent resident population would have to be steadily replaced by newcomers, including new citizens, merely to maintain the current population cluster. Indeed, immigration was largely responsible for the jump in population from 4m to 5.5m over the last 15 years. This is not a problem in itself since Singaporeans are generally open to immigration (after all, everyone can be considered an immigrant within the space of a few generations). However, the pace of this shift has been steadily accelerating and in recent years it has triggered a big debate on Singapore’s future trajectory.
The city-state requires a total fertility rate of 2.1 in order to keep its resident population stable, but the registered rate is just 1.2, a little more than half the “replacement rate”. Urban history shows that once de-clustering takes place, it can gather an unstoppable momentum that is difficult to arrest (ask Detroit).
In early 2013, the government published a White Paper that mentioned a population projection of 6.5-6.9m in 2030. Although the government clarified that the projection was a guideline for infrastructure planning rather than a target, the number came under severe criticism. Part of the hostile reaction may be due to the usual insecurities about economic competition from newcomers, but there is also a more deep-rooted fear about the erosion of the “Singaporean way-of-life”.

Despite its bubbling ethnic mix, Singapore’s economic miracle was made possible by an exceptional degree of social cohesion. At its root, many locals fear that the current pace of change may be too fast to acculturise the newcomers and maintain socio-cultural continuity. In other words, the debate over immigration in Singapore should not be trivialised as xenophobia but seen as a fundamental one about the city-state’s long-term viability.

Singapore’s leaders are aware of these risks and are trying hard to manage contradictory pressures. On one hand, the pace of immigration has been slowed to what is deemed socially acceptable. On the other hand, the government has recognised that Singapore’s urban mass can be increased by leveraging the hinterland. Thus, there is support for urban developments in the Iskandar Development Region in Malaysia. Similarly, a high-speed rail link is being built between Singapore and Kuala Lumpur. The idea is that Singapore the city could be bigger than Singapore the country.

While such strategies may keep Singapore’s economy running for a decade or two, the country’s abysmal birth rates make it inevitable that the resident population will shrink and to some extent be replaced by newcomers. This is why it is important that Singapore begins to think of other ways of maintaining socio-cultural continuity.

In some ways, Singapore’s problem is common to all global cities where the population keeps churning. The reason that cities like London and New York are able to maintain socio-cultural continuity despite changing demographics is that they have anchor institutions that keep the collective memory alive. Institutions that help maintain continuity in London include its universities, museums, theatres, old buildings and traditions, and even the monarchy. Cultural factors such as literature play an important role. No matter who buys/sells real estate on Baker Street, Sherlock Holmes will always continue to live there. New York is similarly served by Columbia, New York University, Central Park, Broadway, and so on.

In short, Singapore needs to make the transition from being an ingenious whiz-kid to becoming a mature city with
a distinct personality. This would be a big shift in the way the
city-state thinks of long-term economic strategy. The good news is
that the ingredients already exist for creating a distinct and lasting
personality for Singapore. As a Chinese-majority city with an Indian
name that started out as a European outpost in South-East Asia,
it is the meeting point of some of the world’s great civilizations.
In the past, this cultural mix was seen as peripheral to Singapore’s
economic model and possibly even as a threat to social peace.
In the long run it may prove to be its single biggest strength. ●

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What are the names behind China’s economic reform drive? How much power do these people have? What are their objectives? These are important as well as difficult questions to answer – particularly so for foreign observers.

The most prominent person to fit the bill today is probably Wu Jinglian, an 85-year-old academic who for thirty years has been at the forefront of policy formulation and applied economic theory in China. Mr Wu was part of a small group of economists that broke with Marxist principles in the late 1970s. Though branded a radical by more conservative central planners in the mid-1980s, he was able to translate his ideas into domestic policy prescriptions that were adopted by successive leaders from Zhao Ziyang to Zhu Rongji and Jiang Zemin. Today Mr Wu’s network of influence can be traced through to the likes of central bank governor Zhou Xiaochuan, finance minister Lou Jiwei as well as Liu He, President Xi Jinping’s childhood friend and foremost economic advisor who was responsible for drafting the recent Third Plenum reform blueprint.

Wu Jinglian’s profile as a public intellectual has been enhanced by two books that were published in the last couple of years. The first, in Chinese, Twenty lectures on China’s Economic Reform: Relaunching the Reform Project, consists a series of interviews given to Ma Guochuan. The second is the English-language Voice of Reform in China, a bibliographical sketch and compilation of translated past papers.

Both books show that Mr Wu sees innovation and institutional reform as the two drivers of economic reform. That is to say, China’s next growth spurt will come from better using existing technologies and shifting the country’s institutional framework further away from central planning and towards market- and rule-of-law based systems of resource allocation. This means, for example, curbing the rent-seeking behaviour of officials and overcoming the inertia of vested interests in the current system. It also helps explain President Xi’s unprecedented anti-corruption drive and reconsolidation of political power at the very top.

The next challenge will be to dismantle the monopolistic or oligopolistic structures of many state-owned enterprises (SOEs), Mr Wu goes on to insist, which could be far more productive if run as competitive private companies. The aim is to achieve a more diversified system of ownership built on a modern and liberalised financial market. This is a major departure from traditional communist orthodoxy, where the financial system has only a limited role and the state-controlled banking sector lacks independence. But it necessitates moving beyond a situation in which the stock market is basically “a casino without rules,” a zero-sum game and a hotbed of rumours and manipulation. The basic requirements of such a transition are better information transparency, proper regulation and an abbreviated listing process.

Finally Mr Wu opposes the temptation to drift back into inflationary, stimulus-driven growth. He argues that China only has a relatively short window for successfully making the transition towards slower, more balanced and intensively-driven growth. He also observes that ultimately there is unlikely to be a “China model” that will allow the sidestepping of individual freedoms and constitutional democracy that throughout history have been consistently associated with great power status.

Invited to speak as part of Deutsche Bank’s Ideas lab lecture series, Professor Forrest Capie of Cass Business School argued that financial regulation is a substitute for trust. At the same time he told the audience it is a myth the last financial crisis was a product of deregulation. There was no sudden loosening of the rules – rather steady changes to regulation have occurred throughout the 19th and 20th centuries. Indeed, Professor Capie explained that periods of history with the lightest regulation have had the fewest crises.

He opened his speech by saying it was the absence of trust that caused the global economy to crash. Everyone would agree that trust is good for an economy; it reduces transaction costs and helps things run smoothly. So an important question to ask is: does the economy import trust or does the market generate it? Professor Capie believes it is generated. The difficulty is that trust, or “social capital”, cannot be measured. It does not fit into mathematical models with inputs and outputs, yet it is fundamental to our society. Although trust in our government, our people, our banks and our companies is essential, the latest financial crisis destroyed it, he argued.

But it has not always been this way. Between the 15th and 18th century, the UK economy, for example, was dominated by mercantilism – the promotion of governmental regulation for the purpose of augmenting state power. This generated waste and corruption, and by the end of the 18th century most citizens resented their government. Then along came a financial crisis two decades later and no one knew what to do. Debt, after many wars, was 300 per cent of output, banks were defaulting, unemployment was vast and there were riots in the streets. The thinking was that something was fundamentally wrong with the system, so the reaction was to deregulate. The government was no longer trustworthy so it was diminished, the gold standard was reinstated and joint stock banks and limited liability companies were allowed. For the next forty years the UK experienced higher growth rates than ever seen before. The reaction to any financial crisis was to deregulate further until the crisis in 1866 – at this point regulation was very light indeed. And for the next 100 years there were no financial crises, Professor Capie counts the 1930s as an economic crisis not a financial one, until the 1974 stock market crash. Because the system had been deregulated it was able to run on trust, and so it did, very efficiently.

Then supervisory regulation began in the 1970s after the crash and it gradually grew bigger again. Today trust seems to have vanished. If people do not believe institutions are interested in their outcomes regulation becomes the way to try to ensure everyone is treated fairly. So what happened to the UK and other nations that they became so regulated and lacking in trust? After the First World War, in 1918, governments attained more power. The great depression came soon after, followed by the Second World War. Trust was damaged greatly during these hard times, Professor Capie believes. Then, due to economic problems such as high inflation, governments introduced new regulations and policies to stabilise the economy, a habit that continues right up to today. The reaction of regulating more with each crisis continues to worsen the situation.
Deutsche Bank hosted its annual Shipping Summit on March 25th in New York. Here is an inside peek from some of the meetings and presentations at the conference.

First, a quick reminder of why marine shipping is critical to international commerce. Seaborne trade fuels China and India’s appetite for raw materials and moves 40 per cent of the world’s crude oil consumption from point of harvest to point of refining. An incredible 95 per cent of all consumer goods are put on a containership at some point. This makes marine shipping a vital link in the global supply chain. Despite this backdrop, low barriers to entry have lead to a fragmented industry and poor capacity discipline, resulting in vicious boom and bust cycles that have created and then erased significant equity value over time.

The current investment landscape was naturally a big theme at the summit. Conversations with dry bulk companies – those that transport iron ore and coal – focused on how management teams will navigate one of the most difficult markets on record. Currently vessel rates average well under $5,000 per day compared with cash breakeven levels of $12,000-$15,000. On the other hand the party is just getting started for shippers of crude oil, where low supply growth and longer trading routes are driving vessel earnings significantly above breakeven thresholds, creating the enjoyable “problem” of surplus cash flow.

Dry bulk companies said they would prefer the market to stay depressed for an extended period of time. Their thinking is that the smaller, less well capitalised owners will not be able to absorb the daily cash burn and will be forced to scrap vessels. This reduction in supply will thus drive up rates. There is obvious economic merit to this argument but it does seem like cutting off one’s nose to spite the face. With the benefit of hindsight, today’s weak environment should have been relatively easy to predict: dry bulk vessel capacity increased by 60 per cent from 2008 to 2012, the largest-never increase over a five year period in at least the last 45 years. In fact, dry bulk capacity has increased every year since 1970 except for two, 1986 and 1987, which were preceded by a very weak prices and record levels of scrapping.

In contrast, the discussions with shippers of crude oil and refined oil products were buoyant. Shifting patterns in energy production, consumption, and refining capacity are creating demand for oil tankers. Shippers of crude oil appeared to be the most bullish as sharply lower US crude imports, thanks to the shale revolution, together with disproportionate increases in Asian refining capacity, are increasing the distance between where oil is harvested and refined. That coupled with low supply growth is driving rates to above $50,000 per day, compared with breakeven levels of $25,000-$30,000 per day.

If anything, the summit was a reminder that shipping companies should not all be painted with the same brush. There remains potential for significant equity value growth so long as investors are in the right part of the industry.
Infographic—Getting connected in Asia

Transport connections between countries’ two largest cities

Average train speed (km/h)

- Shanghai—Beijing
- Tokyo—Osaka
- Seoul—Busan
- New Delhi—Mumbai
- Jakarta—Surabaya
- Bangkok—Chiang Mai
- Kuala Lumpur—Johor Bahru
- Singapore—Kuala Lumpur
- Berlin—Hamburg
- New York—Los Angeles

Number of daily direct flights

Average internet connection speed (mbps)

- China
- Japan
- South Korea
- India
- Indonesia
- Thailand
- Malaysia
- Singapore
- Germany
- United States

Source: Akamai
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