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CHINA'S LONG MARCH TOWARD FREER MARKETS

SEPTEMBER 2016

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In Perspective: China's Long March Toward Freer Markets

China's economic miracle—its 30-plus year path of rapid advance and development to become the world's second-largest economy—is often seen as uniquely Chinese, an isolated case of policymakers luckily pulling all the right levers to conjure growth. To us, though, a longer perspective shows China's miracle bears broad similarities to Taiwan's, Korea's and Japan's (with some admittedly Chinese characteristics). We believe a look at how China's "miracle" resembles those before it—and at some key differences—can add valuable perspective on its present situation and the likely path forward.

> ...a longer perspective shows China's miracle bears broad similarities to Taiwan's, Korea's and Japan's (with some admittedly Chinese characteristics).

The Development Path

Most modern economies have followed a general path of development carrying them from rural, agricultural and subsistence-focused economies to more urbanised and industrial, and ultimately, to a consumption and services-based economy.

In the West, this development occurred over the span of a few hundred years. But across Emerging Asia, a number of countries—Japan, Taiwan, Korea and now China—catapulted themselves along this path, going far along this development path in mere decades. By deploying sweeping land reforms, crude-but-forceful industrial planning and credit direction, these nations were able to focus growth into a short period of time. Of the four, China has arguably moved quickest.

The development path followed by Japan, Korea, Taiwan and China is marked by a basic set of common traits. Their specific methods, means and implementation are not always the same, but the goals and outcomes are similar. This path has three distinct periods: first, a period of land reforms that transfer the value of agricultural production from the hands of a few to a much broader set. The resulting uptick in per capita wealth created an excess of savings that, through a set of banking controls and state-directed national policies, were funneled towards a select group of export-focused industries that financed the development path's second stage. In the third stage, marginal returns to national production diminish and export-oriented policies, banking and capital controls are loosened and removed. The removal makes way for more market-based systems supporting previously neglected portions of the economy (e.g., services and consumption), diversifying the economy and injecting market outcomes into decision making.

This is not to say there is an easy-to-follow "recipe" for managing economies. Obviously, with systems so complex and adaptive as national economies, policymakers can never have complete foresight or insight as to the impact of their choices. As one might expect, attempting to rapidly modernise can easily encourage malinvestment. And, as market forces increasingly take root in nations following this transition path, policymakers' impact wanes. The model China is following has a history of ending in crisis, as Japan, Korea and Taiwan all illustrate. As we will address, market-oriented reforms do come with some risk for China as they did for its predecessors. But this risk is manageable at present, Chinese officials seem wary and vigilant of such past outcomes, and China has a powerful incentive to do what it can to mitigate this risk.

The First Stage: Land Reforms

Japan, Korea and Taiwan share an agricultural system rooted in Japanese tenant-farming structure, as the latter two were part of Japan's pre-WWII empire. Chinese land reforms, as one might expect, differ slightly in the sense outright land ownership was never introduced. However, in looking at the process to give tenant farmers a greater stake in farm productivity and output, it becomes clear the process bears similarities.

Japanese Reforms

In pre-WWII Japan, rural society was dominated by landlords, represented by the House of Peers (the pre-war upper house of Japan's parliament). The system meant most farming activities were performed by renters and tenants, although it should be noted Japanese landlords were not exclusively extraordinarily wealthy individuals owning huge tracts of land. Many were small farmers whose families were incapable of farming the land effectively due to a lack of manpower and modern technology, so they rented out farmland to tenants.[i]

After the war, Japanese agricultural capabilities were devastated. The American military government under General Douglas MacArthur was keen to reform the historical quasi-feudal land ownership structure. The US believed spreading ownership would enhance the stability of government, reduce the ability of extremist politics from rising anew and forestall a potential communist revolution. The first reform, passed in early 1946, employed de-facto eminent domain, forcing absentee landlords (those defined as not residing in the village, so as not to hit the aforementioned small landlords) and those in the village owning tenanted land in excess of one hectare to sell to the government. Landlords subject to forced sale were compensated with Japanese national bonds. This was designed, and in fact pitched, as "land-to-tiller" reform. 1952's Agricultural Land Law built on this theme, and established strict tenancy rights limiting a landlord's ability to evict a tenant farmer. Not surprisingly, these reforms combined with the peacetime reintroduction of fertiliser and improved technology boosted Japanese farm output massively.

Taiwan and Korea's historical land-use policy follows similar pre-war lines as Japan's, due to imperialism. Both were essentially suppliers to strictly controlled markets in Japan. The war destroyed this connection.

Korean Land Reform

The Korean War greatly impacted the pace and shape of Korean agrarian land reform. Prior to WWII, landlords, again a function of Japanese imperialism, amounted to roughly 3.6% of the populace in 1930 while 77.5% of farm households were either tenants or part-tenants.[ii] But the vast majority of arable land in South Korea was owned by large, often absentee, landlords.

As in Japan, the American military government strongly backed land reform, and even introduced the first attempt in 1945. The military government capped tenants' rent rate at 33% of gross annual products, which struck at Korean absentee landlords' historical practice of soaking tenants with exorbitant rents. The military government followed this in 1948 by distributing the property of the New Korea Company—the holding firm established to run and manage formerly Japanese owned farmland—to tenant farmers. This move alone, when finalised, put nearly 30% of total Korean farmland out of the landlords' reach.

While the US could enact some moves unilaterally, it desired the cooperation of the South Korean government. South Korea's first president, Syngman Rhee, initially vetoed a US-backed 1949 attempt at land reform that would have mandated landlords sell to the state for "fair" compensation—quasi-eminent domain. However, this proved to be a temporary delay, as the vast scope of the Korean War's destruction—coming on the heels of WWII's damage—left few vested interests with sufficient economic and political influence to head off reform.[iii]

After a slight tweak to the level of compensation deemed "fair," reforms were enacted and implementation began during the Korean War, in 1950 – 1951, a pace likely motivated by the obvious force of "reform" in the Communist-controlled North. Korea's reforms aimed to give tenants a direct stake in farm outcomes, and made nearly 1 million tenant farmers small landowners.[iv] Under the system, the Korean government bought the land of absentee landlords and select other landowners and sold them at relatively inexpensive rates to resident farmers—again, quasi-eminent domain. While far from executed perfectly, this transference put production in the hands of those who owned the land and enhanced their property rights dramatically.

Taiwan, the JCRR and Post-WWII Land Reform

The origins of land reform in Taiwan were laid by the Chinese Communist Revolution (1949). Prior to its defeat in China's Civil War, the Nationalist government under Chiang Kai-shek was actively working with US help to boost agricultural output and development under the auspices of the Sino-American Joint Commission on Rural Reconstruction, or JCRR. After the Communists' victory caused the Chinese Nationalists to flee to Taiwan, the JCRR moved with them. A significant share of US aid to Taiwan was directed to the JCRR, which served as a quasi-central planning office for agricultural development.

Economically, Taiwan, like many parts of Asia, was a tumultuous place in the immediate aftermath of World War II. The island was controlled by Japan until 1945. When the Chinese Nationalists invaded, they seized the property of Japanese citizens and dispatched most of them back to Japan. However, its agricultural economy was a mess, as Japan was its primary market and source of financing. During the 1950s, the JCRR coordinated a massive reform effort. It educated farmers about irrigation methods, encouraged new crop development and pushed for the increased use of technology to boost output. On the land front, the JCRR's moves were controversial, but had the desired impact of increasing output. The government sold public land to tenant farmers, tied caps on land rent to expected harvests and, finally, used eminent domain-style legislation to break up huge landowners' stranglehold on property ownership. Fairly crude and heavy-handed methods, but the result was a huge increase in agricultural output.

Land Reforms with Chinese Characteristics

The Communist's 1949 victory in mainland China was followed by a period of approximately 30 years in which farming collectives dominated the agricultural structure. Such agricultural collectivism, in which private farming was ultimately outlawed, was a key feature of the Mao Era in China—the antithesis of the eminent domain employed in Japan, Korea and Taiwan. The lack of individual ownership and central direction reached its peak in the Great Leap Forward, which directly led to millions of deaths through starvation.

Partly in reaction to famine and under Deng Xiaoping's reformist influence, strict agriculture collectivism was reversed. The new system granted individual families direct leasing rights and market access for their products. (Further enhanced by China's 2001 entry into the World Trade Organization, which mandated it remove agricultural protections, a positive influence on competition and prices.) Many went so far as to reduce the size of collectives to the family unit, allowing self-interest to guide farming. The result: A boom in yields and rising wealth, as farmers benefited from their own improved production, unlike under collectives.

Ultimately, even small plots in China were still state-owned after the land reforms, unlike farms in Japan, Taiwan and Korea. Despite this "uniquely Chinese" difference, the similarities of China's land reforms (individuals benefitting from their own farm production) led to a similar outcome: broad wealth creation, farm productivity gains and improved labour force utilisation. Moreover, China's policy of maintaining state ownership of farmland facilitated later steps along the development path, as the government entities were able to dictate urbanisation through not only fiscal policy, but land use restrictions and even outright sales of property.

Stage Two: Export-Oriented Manufacturing and Urbanisation

In the second stage, the broad-based increase in wealth driven by agricultural reforms created excess savings, which the government funneled to export-oriented industries through heavily state-directed sectors. Such preferred entities were supported in each country through a system of financial controls, like interest-rate caps on loans, price floors and capital controls that had the effect of providing ample and low-cost source of financing. Central-planning agencies (Exhibit 1) had a decisive say in which industries were favoured, with export firms particularly supported and protected indirectly through foreign-exchange rate pegging. In addition, a system of subsidies and tariffs protected domestic industries from competition, though they likely had a deleterious effect on the broad economy.

Exhibit 1: Planning Agencies Set the Course

Country	Planning Agency	Acronym
Japan	Ministry of International Trade and Industry	MITI
Korea	Economic Planning Board & Ministry of Trade and Industry	EPB & MTI
Taiwan	Council for Economic Planning and Development	CEPD
China	National Development and Reform Commission	NDRC

Japan

Japan and Korea pursued a similar path whereby industrial policy was set by an arm of the government. In Japan, the Ministry of International Trade and Industry (MITI) directed economic policy, and industrial policy was essentially a rebuild. The country had modern industry prior to WWII, having gone through industrialisation at a similar time as Great Britain, France and the United States, but it was in shambles after the war. Additionally, the prewar Japanese economy was inefficient—dominated by the zaibatsu, huge family-owned industrial conglomerates that controlled large segments of Japan's economy.

After WWII, the zaibatsu were liquidated, introducing the keiretsu cross-shareholding structure common in Japan today. While there are problems with this structure, the reform succeeded in increasing competition. And it came at a beneficial time, when the General Agreement on Tariffs and Trade was opening global trade after the 1930s' and 1940s' rampant protectionism. Japan positioned itself to export many goods to the US, which was in a vastly better economic state than most of Japan's former trading partners in its empire.

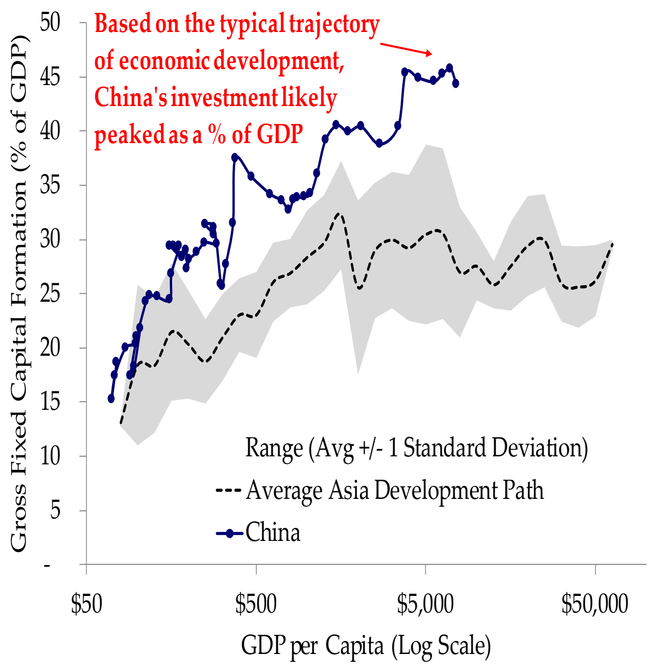
MITI benefited Japanese industry greatly by acting as a single buyer of modern technology from foreign suppliers, then disseminating it across industries. MITI also negotiated hard deals involving short patent periods on said technology, allowing Japanese industry to mimic imported technology in relatively short order. The growth and investment this unleashed was explosive; and the punditry's reaction to it is reminiscent of today's reaction to China. As Chalmers Johnson documented in his MITI and the Japanese Miracle, when The Economist magazine published a two-part series in September 1962 lauding Japanese growth, it met with Japanese "pundits and economists … writing cautionary articles about how the boom would fail, about the crises to come, and about the irrationality of government policy."[v] Ironically, 1962 is much nearer the dawn of Japan's rise than the sunset.

As agricultural productivity rose, and incomes increased, savings increased dramatically—which served to finance investment in the manufacturing and export sector.

As agricultural productivity rose, and incomes increased, savings increased dramatically—which served to finance investment in the manufacturing and export sector. In the early 1950s, MITI advised the Japanese Development Bank's credit allocation and system of loan rediscounting supporting preferred industries like electric utilities, steel, shipbuilding and coal—all necessary to help the country build manufacturing and export muscle. MITI also controlled foreign exchange, fixing the yen. In addition, MITI kept tariffs high, an effort to protect fledgling industries—tariffs that likely hurt as much as they helped, but they do illustrate the degree of intentional development planning and orchestration of the economy by MITI.

The same process was more or less mimicked across Korea, Taiwan and China, as Exhibit 2 illustrates.

Exhibit 2: Export and Manufacturing Focus Drives Investment Surge



Source: IMF, 1960 to 2013.

Korea and Taiwan

In Korea and Taiwan, policymakers largely looked to Japan as a development model, even going so far as Korea's Ministry of Trade and Industry collaborating with Japanese officials in an attempt to mimic the boom.

Like Japan, Korea sought to create and then support large export-oriented manufacturing conglomerates called the chaebol, though their structure resembled the old zaibatsu much more than the keiretsu. Also like Japan, Korea pursued a highly protectionist stance toward trade and investment, outright blocking imports of goods it believed could be produced locally. Further illustrating its tight connection with Japan, many chaebol launched joint ventures with similar firms in Japan—one such firm is Samsung Electronics, born as a division of Samsung in 1969 to manufacture transistor radios in a joint venture with Japanese firm Sanyo.[vi]

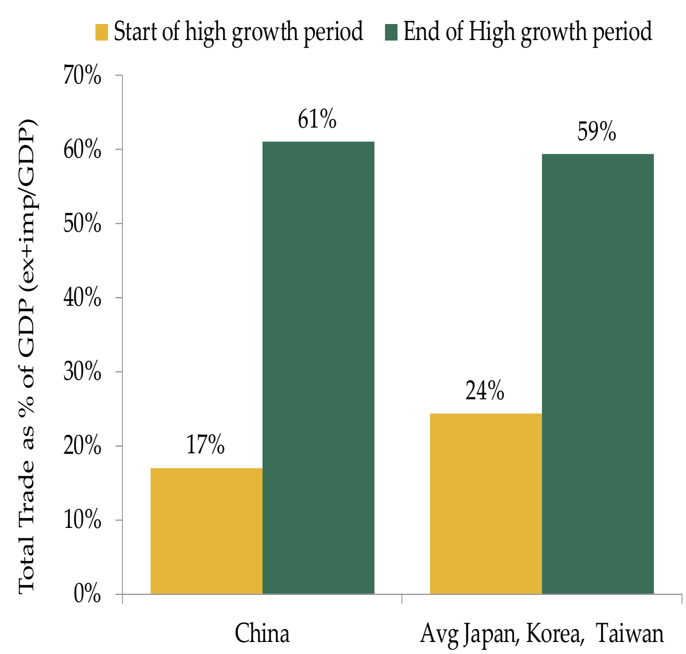
Like Japan, Korea managed the dollar/won exchange rate throughout its period of rapid development to aid exporters. The won was seriously devalued (on a nominal basis) on three occasions between 1970 and 1980, when the country ditched the outright dollar peg for one linking the won to a basket of currencies. However, the basket weights were never revealed, and the International Monetary Fund officially considered the policy a managed float targeting the dollar/won rate. In 1990, the basket was ditched and the dollar again targeted, with the value determined within a range based loosely on the prior day's closing value. This evolution bears some striking resemblances to China's recent moves, as we will discuss.

In Taiwan, the Council for Economic Planning and Development drove policy direction, but Taiwan's primary support mechanism was a currency peg, which supported export-oriented firms in the global markets. Taiwan pegged its dollar unnaturally low from 1961 through 1985, amassing huge foreign exchange reserves that totaled roughly 70% of GDP by 1987. From an industrial standpoint, the Council used the banks (already nationalised as of 1949) to direct credit to very large exporters, which the state owned.

China

In China, policy direction was set by the National Development and Reform Commission and supported by a combination of mechanisms including a currency peg and direct loans through state-owned banks. The effect of policy direction combined with support and subsidy of export-oriented firms resulted in each country growing exports as a share of GDP dramatically over this phase (Exhibit 3).

Exhibit 3: A Path to Wealth - Export Drives High Growth

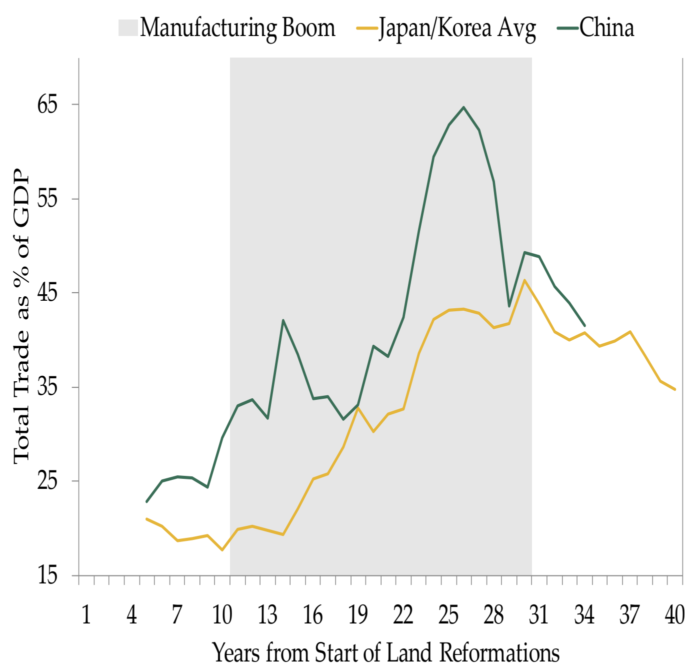


Source: Boltho/Weber, 2009. China high growth period 1980 to 2005; Japan high growth period 1950 to 1975; Korea high growth period 1965 to 1990; Taiwan high growth period 1960 to 1985.

Like peers, China historically maintained a fixed exchange rate meant to support exporters. But to simultaneously maintain a fixed exchange rate and control monetary policy China had to block capital flows. Marrying a fixed currency, control of monetary policy and free capital flows is known in economics as the "impossible trinity"—an unsustainable practice, which would create an unending arbitrage as investors would borrow in low interest rate countries and invest the funds, with no currency risk due to the peg, in countries with higher rates. As China liberalises and allows greater freedom of capital movements, it must move to a floating currency. Assuming China remains on its current reform path, foreign exchange liberalisation is likely only a matter of time.

As each country developed, it relied less and less on trade, turning toward domestic consumption and services-industry growth. As Exhibit 4 shows, trade's importance is highest during the booming period of manufacturing-led growth. As the focus of growth shifts, trade's share of GDP declines.

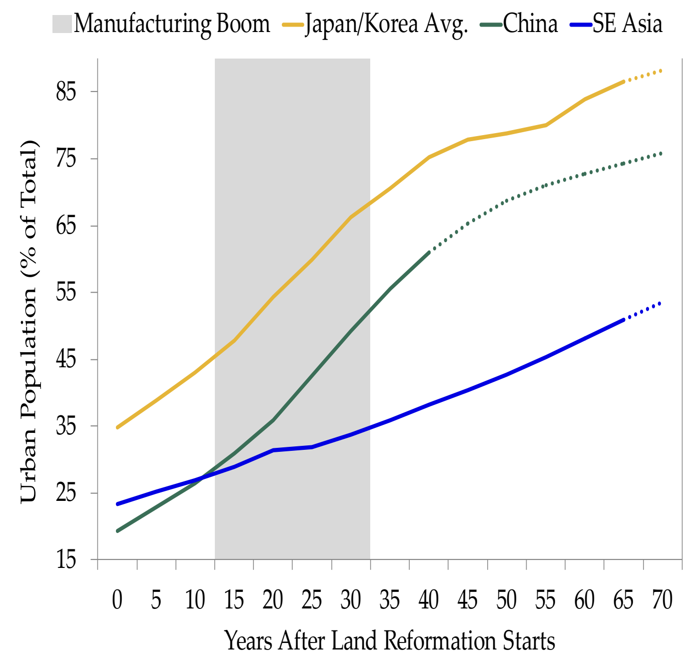
Exhibit 4: Trade Importance Booms Then Fades



Source: World Bank, as of 31/12/2015. Japan period is 1945 to 1955. Korea period is 1950 to 1960. China is 1980 to 1990.

Additionally, as industrial sectors grew, more and more formerly rural citizens moved toward population centres seeking work. As such it is easy to see in Exhibit 5 that population gradually moved away from the countryside and into cities.

Exhibit 5: Urbanisation Rates - Japan & Korea vs China and SE Asian Peers



Source: United Nations, as of 30/6/2016. Japan period is 1945 to 2015. Korea period is 1950 to 2020. China is 1980 to 2050.

China's urbanisation has been exceedingly rapid, which is possibly a byproduct of the aforementioned fact farmers have no actual ownership of property. As Chinese local governments' finances have become strained in recent years (they receive little or no national revenues), local officials have sold valuable land to help pay the bills. The farmers get next to nothing and are displaced, potentially contributing to the fast urbanisation. This trend also runs political and social risk as unhappy farmers and trends in food security potentially collide. But in terms of supplying a ready, urbanised workforce for heavy industry, it is effective.

The Final Stage: Market Reforms, Consumption and Services

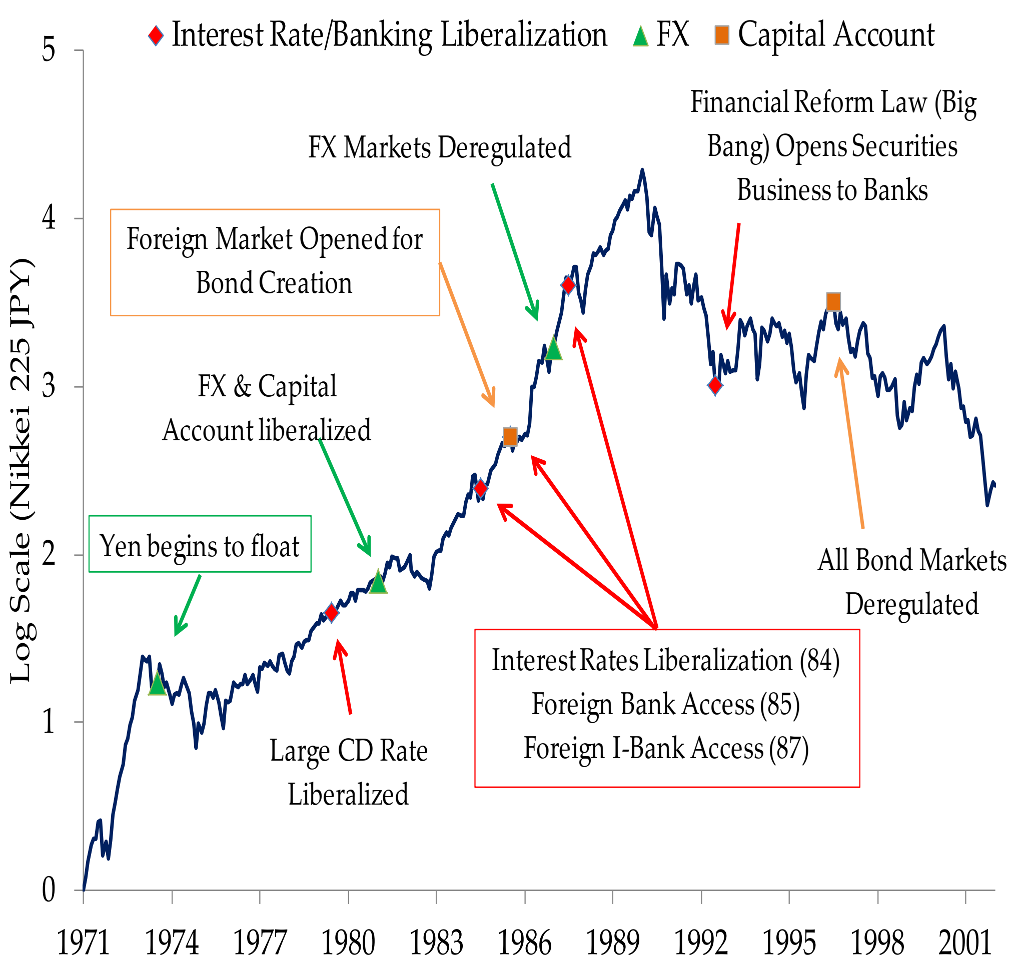
The final stage in the development arc is opening the financial system and relaxing many of the restrictive policies enacted to spur growth through manufacturing and exports, resulting primarily from focused extensions of credit and foreign exchange practices.

Japanese financial liberalisation began in the mid-1970s, and by the mid-1990s, virtually all interest rates were market-set, and foreign exchange markets were open. The earliest steps were in the foreign exchange markets. After a brief attempt to maintain the yen-dollar peg failed (December 1971's Smithsonian Agreement, which set the yen at 308 per dollar, allowing it to float in a band between 301.07 and 314.93), policymakers decided to let the yen (among other currencies) float in February 1973, when Bretton-Woods formally met its demise.[vii] The yen doubled against the dollar through the late 1970s, while the Japanese government enacted further reforms.

In 1979, interest rates on large CDs were liberalised, the first in a series of reforms. By 1993, virtually all Japanese interest rates were market-set and upper caps on rates eliminated, ending the post-war regime established by the Temporary Interest Rate Adjustment Law of 1947.

Also starting in the mid-1970s, Japan began to build a secondary market for Japanese Government Bonds (JGBs), and the bond market continued to be a reform focus through the mid-1990s.[viii] In 1984, Japan began gradually opening to foreign investors in its bond markets. In 1992, the Financial Reform Law opened the securities business to banks. And in 1996, all bond markets, including corporates, were deregulated.

Exhibit 6: Timeline of Japanese Market Reforms



Source: FactSet as of 31/7/2016. Nikkei 225 from 31/12/1970 to 31/12/2001, based in JPY.

Korea

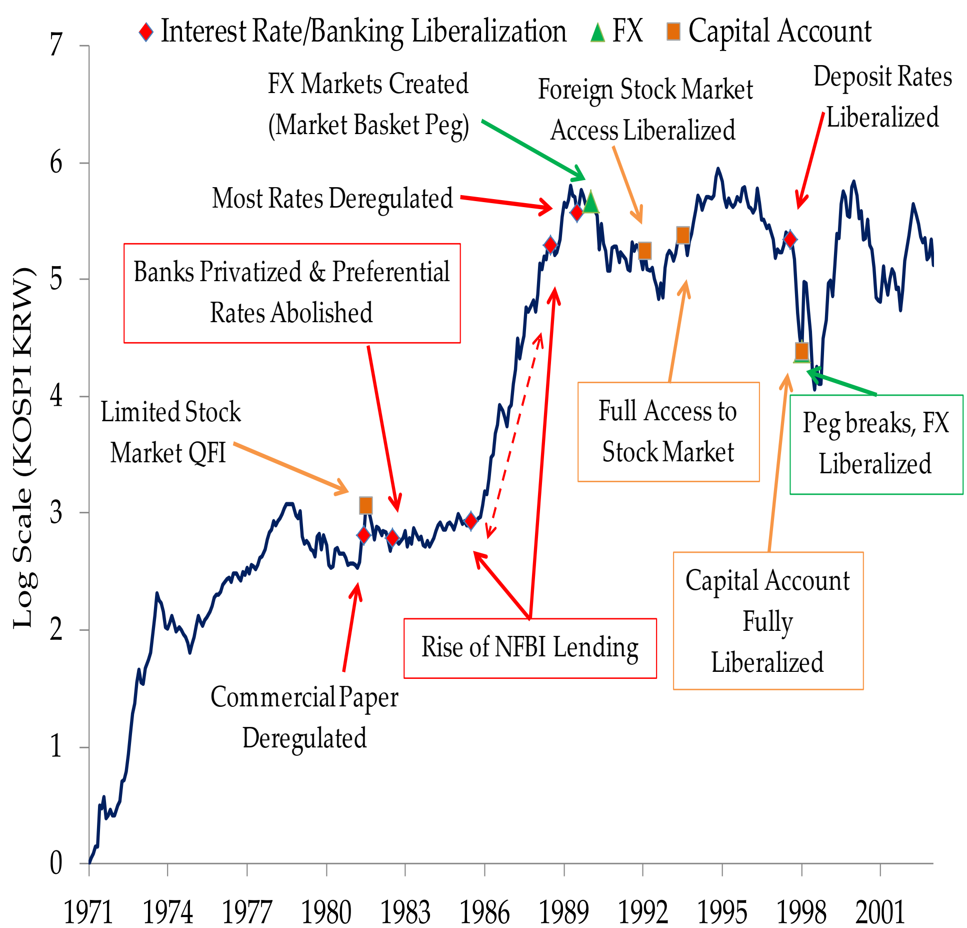
Korean financial liberalisation began in the early 1980s, with the deregulation of the commercial paper market and the limited opening of the stock market to foreign investors. The latter, achieved through 1981's Capital Market Globalization Plan, encouraged foreign portfolio investment though the Korea International Trust and Korea Trust. This was followed by 1984's Korea Fund listing on the New York Stock Exchange, which allowed indirect participation in the Korean stock market.[ix] By 1990, foreign securities firms were permitted to establish offices in Korea, and vice-versa; foreign direct investment was permitted in full; Korean firms could list on foreign stock markets and Korean investors could invest in foreign stocks, which were also permitted to be listed in Korean markets.

Banking was simultaneously undergoing reform. In 1982, commercial national banks were privatised. The same year, preferential loan rates were abolished and by 1988, most lending rates were deregulated—allowing markets to set borrowing costs according to perceived credit conditions.[x]

Alongside these reforms, non-bank financial institutions were permitted—and they flourished. By 1997, non-banks had 63% of Korea's deposits. These institutions fared poorly in the Asian Financial Crisis, exacerbating the damage to Korea's financial system. The country was hit to such an extent that the government nationalised several banks, effectively undoing a key reform.

Finally, in the late 1990s, the capital account and foreign exchange were liberalised. These moves largely came as a result of the Asian Financial Crisis, which led Korea's government to eliminate the aforementioned won/dollar peg. Pegged currencies are typically unstable and subject to pressure, and after the Thai baht was devalued, runs on the currencies of many Asian nations followed.

Exhibit 7: Timeline of Korean Market Reforms



Source: FactSet. KOSPI from 31/12/1970 to 31/12/2002, based in KRW.

Taiwan

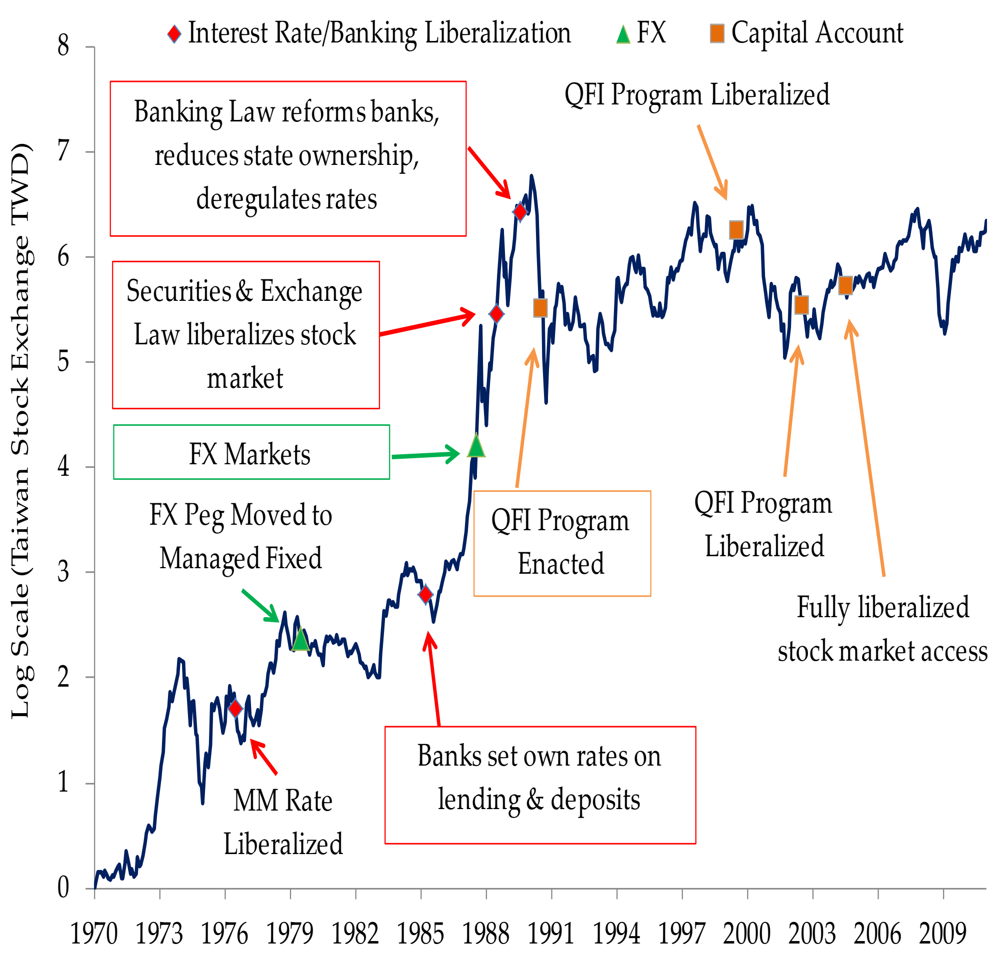
Taiwan's liberalisation began in 1976, when the government freed Money Market rates. Nine years later, banks were permitted to set their own deposit and loan rates and, in 1989, the banking law reduced the state's ownership of banks and freed deposit rates fully. Foreign exchange liberalisation began in 1979, when the government moved from an outright peg to a managed float. In 1987, foreign exchange markets were deregulated, and the currency was allowed to float freely starting in 1989.[xi]

Securities market reforms began in 1986, allowing foreign investors to indirectly participate in Taiwanese markets via the Taiwan Fund. The Securities and Exchange Law followed, which expanded access for local investors and allowed new securities firms for the first time in 15 years. In the 1990s, Taiwan launched a qualified foreign investor programme, which it expanded in 1999 and 2002, before markets were totally opened to foreign investors in 2004.

Deregulation and Destabilisation?

In each country before China, the final stage—liberalizing and deregulating financial markets—ended in some combination of foreign exchange and banking crises or asset bubbles. In Japan, financial liberalisation completed amid large domestic asset bubbles (real estate and equity) as international fund flows and consumer lending fueled speculation. In Korea, the shadow banking system caused overheating, and banking liberalisation culminated in a consumer-oriented equity bubble. Meanwhile, the opening of the capital account and subsequent international flows contributed to a currency crisis during 1997's Asian Financial Crisis. Similarly, Taiwan suffered from bursting asset bubbles (real estate and equity) as speculation drove markets during the later liberalisation process.

Exhibit 8: Timeline of Taiwanese Market Reforms



Source: FactSet. Taiwan Stock Exchange from 31/12/1969 to 31/12/2010, based in TWD.

China's Liberalisation

China is presently modernizing and liberalizing its financial markets, which looks set to continue for the foreseeable future. This may lead investors to wonder whether China's day of reckoning is drawing near, given the historical precedent. However, while China may one day experience a crisis (reform or no), a look at the reform process's standing and the government's firepower to forestall a crisis shows history is not destined to repeat in the immediate future.

China is presently modernizing and liberalizing its financial markets, which looks set to continue for the foreseeable future.

While significant restrictions remain, Chinese financial reforms have come a long way. After the Communist Revolution, commercial banks were nationalised and consolidated into a single central bank: the Peoples' Bank of China (PBoC). The PBoC acted as the sole bank until 1979, when its commercial activities were separated, creating four large and specialised banks: Industrial and Commercial Bank of China; China Construction Bank; Bank of China; and Agricultural Bank of China. The remainder of the PBoC became a central bank with monetary and regulatory responsibilities.

China's National Development and Reform Commission implemented industrial and export policy through these specialised banks. During the manufacturing boom (1980-2000), foreign exchange rates were pegged, interest rates were controlled—often held below the inflation rate—and the capital account was essentially closed. Policymakers set low rates ensuring a source of cheap funding and to maintain solvency of the system. This effectively subsidised national development at savers' expense. Non-export oriented private companies had limited legal access to credit, which caused many to turn to shadow banking markets, not dissimilar to the rise of non-banks in Korea. At first quasi-legal, these markets developed to serve non-export firms and consumers and were ultimately formalised and legitimised. The recent (circa 2013) and rapid development of Wealth Management Products (WMPs) were a way to simultaneously satisfy the demands of depositors for higher rates and for non-export companies to gain access to capital.

At a surface level, that may sound very much like the Korean experience, but there are two key differences between China's shadow banking markets and Korea's. First, unlike Korean NBFIs, which were inefficiently run for the benefit of the chaebol, the shadow banking markets in China remain largely under the control of the same traditional banks making common loans. Second, most of the products have no explicit guarantee, suggesting a rise in non-performing loans embedded in WMPs need not drive a banking solvency crisis. (Although it may require a government bailout.) With the capital account technically open and rates liberalised, the foreign exchange peg is a key remaining piece.

Recent Reforms

China's reforms to this point have focused on liberalizing interest rates, very gradually moving to allow more foreign capital into the bond and stock markets and tweaking foreign exchange policy.

Interest rate reform began as long ago as 1996, when the PBoC deregulated interbank rates. In 1998, loan rate caps were relaxed, and floor rates were removed in 2013. In the foreign exchange market, the hard peg to US dollar was eliminated in 2005, but a de-facto peg has frequently remained.

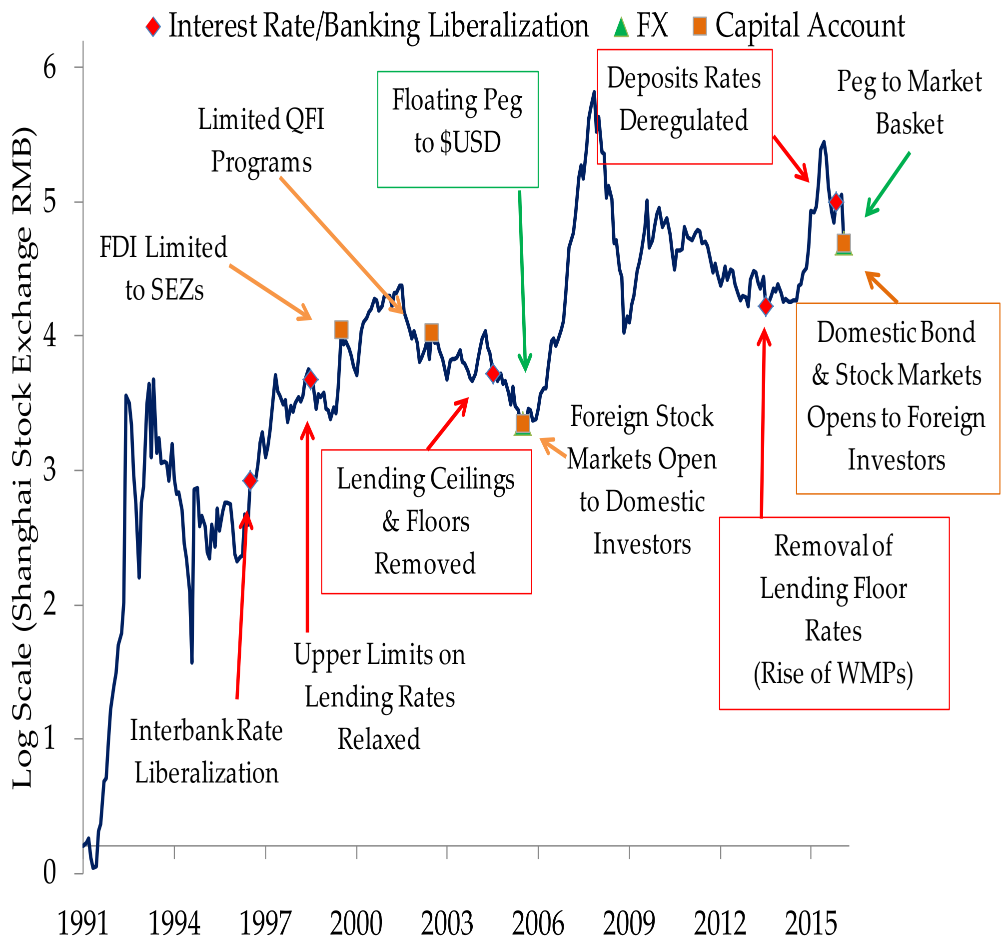
Since 2005, China has officially used a managed float against a basket of currencies, setting a daily reference rate for the yuan and allowing it to trade within a 2% bandwidth (in either direction). The following day, the PBoC would set a new rate that may or may not have anything to do with the prior day's movement. Practically, officials have used this system to manage the RMB/USD exchange rate. From 2005 to mid-2008, they allowed the yuan to strengthen against the dollar, then held the rate steady until mid-2010. Since 2010, a major shift has taken place. While the peg arguably kept the yuan artificially low relative to the dollar earlier, since 2014 the peg has actually acted more like a currency floor, with China propping up the yuan more than holding it down.

In August 2015, it announced it would change this approach and instead take market makers' quotes and the prior day's close into account when setting the rate. The 2% bandwidth remains, and there is still significant room for meddling, but this is actually a market-oriented reform, albeit a modest one.

Market Access

China began opening markets to foreign capital in the late 1990s, when it pilot tested allowing Foreign Direct Investment in selected Special Economic Zones, a key means China uses to test new policy before broadly unleashing it. In 2002, the government allowed a small amount of foreign investment in Chinese domestic stocks through the Qualified Foreign Investor programme. Most recently, China has eliminated caps on foreign investment—influenced no doubt by recent yuan weakness—and opened the fledgling domestic bond market to foreign investors.

Exhibit 9: Timeline of Chinese Market Reforms



Source: FactSet as of 31/7/2016. Shanghai Stock Exchange from 31/12/1990 to 31/3/2016.

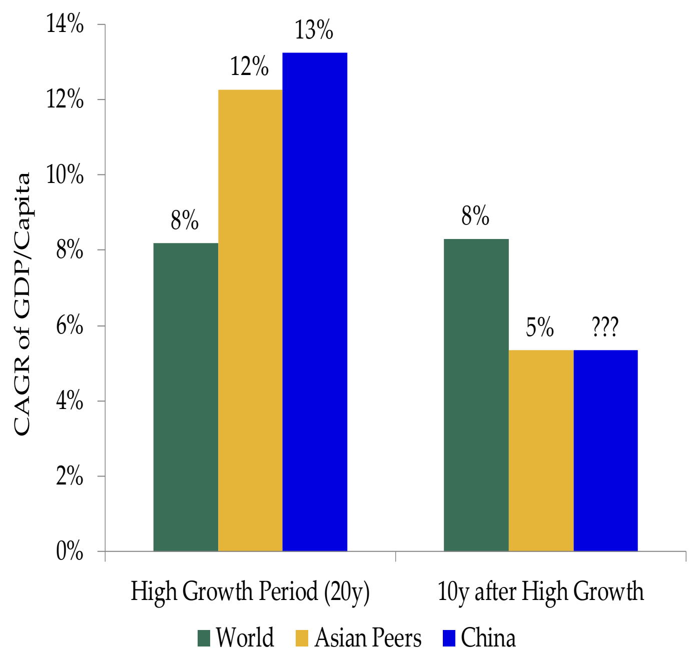
There is much modernisation and deepening needed here—particularly in the bond market. Both stock and bond markets are illiquid and shallow, subject to huge swings and volatile moves. Moreover, China's government has repeatedly intervened in the stock market since early 2015, first attempting to prick an inflating bubble and then to prop up stocks when the attempted prick turned into a pop. The combination of liquidity and government intervention largely explain why MSCI again declined to add Chinese domestic A-shares to its Emerging Markets indexes in June 2016.

Chinese Growth Slowdown

While China has reformed and opened its financial system and economy, growth rates have slowed. Part of this is simply due to the changing composition of growth—services are far harder to measure in output terms than goods, complicating statistical measurement.

The government also dialed back on credit allocation to heavy industry, slowing the industry's feverish pace. However, this is in keeping with its peers' emergence, as Exhibit 10 shows.

Exhibit 10: China Grew Like Peers; Will It Slowdown Like Peers?

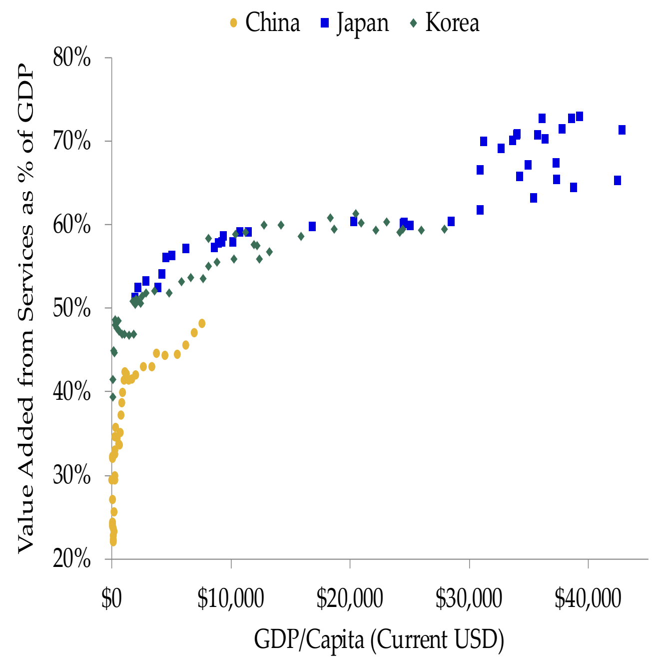


Source: FactSet and the World Bank. The relevant high growth periods are: Japan (1960-1980); Korea (1965-1985); Indonesia (1972-1992); Malaysia (1972-1992); Singapore (1972-1992); Thailand (1972-1992); Taiwan (1980-2000) and China (1990-2010).

However, while the absolute growth rates have slowed, China continues to expand at an overall healthy clip, and the slowdown is masking the rising role of services and consumption in China's economy. Ironically, their rise should actually give China a more diverse economic base—stabilizing growth right at the time many fear it is collapsing. Exhibits 11 and 12 show China's economic evolution over the years from agriculture to manufacturing to services, which recently became the largest segment of China's economy. China's service sector is on a similar path relative to its peers; growing with GDP per capita as rising wealth, increasingly open markets, technology and education drives a transitional phase.

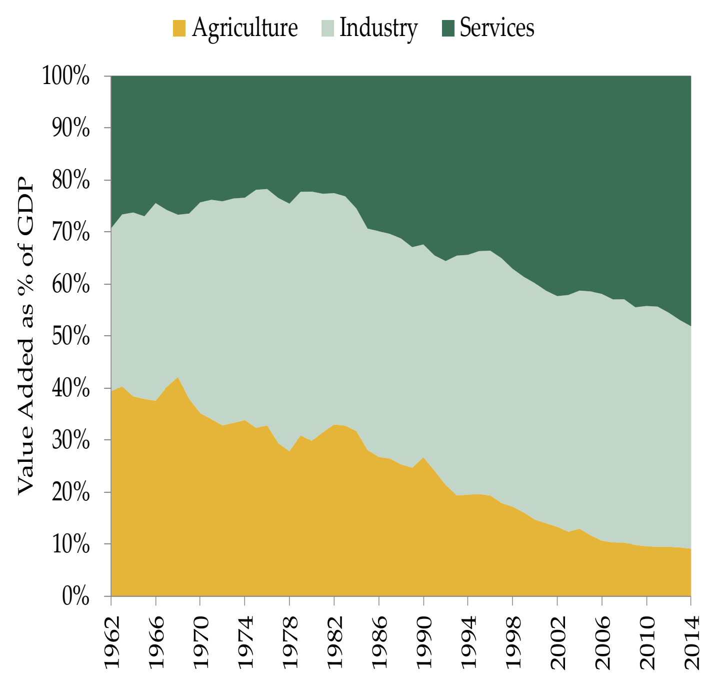
... while the absolute growth rates have slowed, China continues to expand at an overall healthy clip, and the slowdown is masking the rising role of services and consumption.

Exhibit 11: China's Service Economy Is Catching Up



Source: World Bank and OECD national accounts data, from 1960 to 2014.

Exhibit 12: China's Economic Composition Over Time



Source: World Bank and OECD national accounts data, from 1960 to 2014.

The market liberalisation periods of Japan, Korea and Taiwan show transition from a command-oriented economy to a market-based one without crises is challenging. During the transition, misallocations emerge and grow. As such, the banking sector and the capital account should be monitored closely.

China is deep into the concluding phase when the financial system (banking, capital account, foreign exchange) is liberalised. China has deregulated bond financing, interest rates (despite retaining control of traditional lending through quotas and state ownership of banks) and opened much of its capital account. As in Japan, Korea, and Taiwan, Chinese deregulation has contributed to a surge in consumer and corporate debt, though the magnitude of this is debatable. Chinese reform often comes in fits and starts, but should interest rates remain largely deregulated, foreign exchange reform and completely opening the capital account are all that remain.

However, there is little sign China is close to a crisis now. As we have shown, Korea's financial liberalisation took decades of back-and-forth reforms to various aspects before its currency peg broke during a crisis that started externally (the Thai baht). Japanese and Taiwanese development included decades-long financial reforms—that both ended with major financial crises is a noteworthy coincidence, but it does not help pinpoint when a crisis will strike. China could conceivably have many years of sound growth ahead despite embarking on the final leg of development.

But also, the Chinese government has shown it is aware of the risks, and is taking a very gradual path toward implementing reforms. For example, the government introduced the concept of allowing corporate issuers to default on domestic debt—not bailing them out—in mid-2014, when Shanghai Chaori Solar encountered financial difficulty. However, after that news splashed across headlines the world over, the government quietly stepped in and bailed the firm out.[xii] While some see this is a lack of commitment to reform, there is another way to view it: The public announcement is a declaration that market-oriented reform is coming and a demonstration of what that means. Since that initial occurrence, officials have allowed corporate defaults, like those of Baoding Tianwei, Kaisa Group and Yingli Solar to proceed, suggesting the will is there. We believe Shanghai Chaori is an example of cautious market-oriented reforms.

Moreover, the PBOC has substantial tools to manage risks that accompany the liberalisation of a previously closed market. The country maintains significant foreign exchange reserves and a current account surplus combined with additional inward capital account reforms. Furthermore, any Chinese banking crisis could be mitigated through recapitalisation, funded by China's vast foreign exchange reserves. This has happened on six separate occasions since 1998, and we believe China's leadership is willing and able to do so now, if needed.

Presently though, sentiment toward China is overly dour in our view, detached from the positives of a strong absolute rate of growth and increasing market orientation. China's economy is not plummeting—it has been slowing in a fairly orderly fashion for years, having passed the stage of economic development when huge infrastructure spending results in huge economic growth rates. China is now transitioning to a more consumption-oriented economic model, as its peers did earlier. This transition likely means sustained healthy, but slower, growth ahead.

All told, we believe China's market-oriented reforms are necessary and long-term positives—though it is certainly possible they periodically shake investors' nerves along the way.

All told, we believe China's market-oriented reforms are necessary and long-term positives—though it is certainly possible they periodically shake investors' nerves along the way. Chinese officials are no more immune from missteps than politicians anywhere—if anything, they may be more prone to occasional errors as they attempt to narrowly manage one of the world's largest economies and successfully shift it from a command-based system to one that operates more openly. However, we believe China will continue growing apace for the foreseeable future—the next 12 to 18 months—as it provides its significant economy and population opportunities to participate more freely in global markets. The dour sentiment toward its economy and reform seems disconnected from this reality.

Should you have any questions about any of the information provided above, please contact FIE by mail at 2nd Floor 6-10 Whitfield Street, London W1T 2RE or by telephone at +44 (0)800 144-4731.

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