

Beware the Dragon

Expert views on risks and opportunities in China



TABLE OF CONTENTS

1	Introduction	1
2	Insuretech in China: Revolutionizing the Insurance Industry Cliff Sheng, Partner and Head of China, Oliver Wyman	2
3	Will Common Ground Between the US and China Strengthen Their Bond? Knowledge@Wharton	4
4	Beware the Dragon: The Global Impact of a China Hard Landing Jamie Thompson, Head of Macro Scenarios for Oxford Economics	7
5	China's Rise: The AIIB and the "One Belt, One Road" David Dollar, Senior Fellow with the Foreign Policy and Global Economy and Development for the Brookings Institution	10
6	Developing a Blue Economy in China and the United States Michael Conathan et al., Director of Ocean Policy at Center for American Progress	13
7	Debt, Not Reserves, to Constrain China's Cross-Border Buying Spree Alicia García Herrero, Senior Fellow for BRUEGEL and Chief Economist for Asia Pacific at Natixis	16
8	Is it "Deja Vu All Over Again" for China's Financial Well-Being? Jack Rodman, Senior Advisor for Crosswater Realty Advisors	18
9	Real and Imagined Risks of China's Shadow Banking Christian Edelmann et al., Global Head of Corporate and Institutional Banking for Oliver Wyman	21
10	China's Aging Population Prepares for Tomorrow Julio Portalatin, President and CEO of Mercer	23
11	One Belt, One Road: Risks and Countermeasures for Chinese Companies Miao Lu, PhD, Executive Secretary General of the Center for China and Globalisation	25
12	How Should Business React to China's Water Crisis Cate Lamb, Head of Water at CDP	28
13	China's Aging Population: More than Fifty Shades of Grey Jacques Penhirin et al., Partner at Oliver Wyman, China	30
14	Behind China's Attempt to Spread the Risks from its Debt-financed Growth Prasenjit K. Basu, Founder at REAL-Economics.com	32
15	China Continues to Battle Massive Capital Flight Problem Alicia García-Herrero, Senior Fellow for BRUEGEL and Chief Economist for Asia Pacific at Natixis	34

INTRODUCTION

The articles contained in this publication have been selected for the ways they examine economic, political, and societal issues for China. The compendium collates knowledge and expertise from the world's leading experts to provide practical and timely insights on the various risks and opportunities associated with China's unprecedented economic growth over the past decade.

All articles first appeared on [BRINK](#) – a digital platform that informs global decision-makers on critical growth and innovation topics. BRINK is made possible by Marsh & McLennan Companies, and managed by Atlantic Media Strategies, the digital consultancy of The Atlantic.

INSURETECH IN CHINA: REVOLUTIONIZING THE INSURANCE INDUSTRY

Cliff Sheng

Partner and Head of China, Oliver Wyman



China is among the countries at the forefront of fintech innovation and adoption, and the latest technology is now being used there by the insurance industry to better serve its clients.

Capital markets that can support financial innovation are not yet mature in China, and existing state-owned financial institutions are not reforming quickly enough. This gap in supply has provided opportunities for Chinese fintech players – who are being supported by rapidly growing online ecosystems and a tech-savvy population – in diverse fields ranging from investing to payments.

A GROWING INSURANCE MARKET

While insurance penetration in China is currently low (3.6 percent

in 2015) compared to developed markets such as the UK (10 percent) and the US (7.3 percent), strong government support, coupled with a growing middle class, is making insurance products more accessible. In 2015, for example, total insurance gross written premiums (GWP) in China increased by 20 percent in 2015 to 2.4 trillion yuan (\$355 billion).

In fact, the Chinese insurance market has doubled in size over the past six years. Based on China Insurance Regulatory Commission's (CIRC) five-year plan and various other sources, the insurance market is forecasted to grow at 13 percent (compounded annually) up to 2020, to 4.5 trillion yuan.

The rapidly growing insurance market – albeit from a low base – in China, is also opening up plenty of opportunities for Insuretech

(defined as insurance further enhanced through technology in a customer-centric way) players.

INSURETECH MAKES GAINS

Insuretech is revolutionizing the insurance industry by bringing disruptive products and services to a market that is fast adopting and increasingly moving towards an online ecosystem. The market is also seeing a surge in the number of people who have started to understand and are aware of the benefits of insurance.

These gains have been supported by the insurance market regulator CIRC, which has fostered a supportive regulatory environment insuretech. All of this is resulting in rapid growth in the Insuretech market, which is expected to grow from 250 billion yuan in 2015 to more than 1.1 trillion yuan in 2020.

There are broadly three Insuretech segments in China (Figure 1), the market sizes for which are projected to grow at different rates:

ONLINE DISTRIBUTION OF TRADITIONAL INSURANCE PRODUCTS (E.G. ONLINE AUTO INSURANCE SALES)

According to Oliver Wyman estimates, GWP for this segment will grow from about 207 billion yuan in 2015 to about 747 billion yuan in 2020. And within this

segment, non-life insurance products will grow at a faster pace than life products.

TECHNOLOGY ENABLED UPGRADES OF EXISTING INSURANCE PRODUCTS (E.G. NEW HEALTH INSURANCE POLICIES OR PRICES BASED ON WEARABLE DEVICES, TELEMATICS)

GWP for this segment is expected to grow from about 28 billion yuan in 2015 to about 197 billion yuan in 2020. Auto insurance will be the highest contributor to this growth, followed by health insurance products.

ECOSYSTEM-ORIENTED INNOVATION OF NEW INSURANCE PRODUCTS (E.G. SHIPPING RETURN INSURANCE, FLIGHT DELAY INSURANCE)

Estimates show that GWP in this segment will grow from 12 billion yuan to 202 billion yuan between 2015 and 2020. The key contributors to this growth be the e-commerce and travel ecosystems because of their large market size and the growing desire among consumers

to protect themselves against risks related to these ecosystems.

RISKS AND UNCERTAINTIES FACING THE INSURETECH INDUSTRY

Notwithstanding the tremendous scope and opportunity for certain simple products—such as travel insurance and shipping return insurance—in the Chinese Insuretech market, several products such auto insurance and universal life insurance face uncertainties owing to the following four factors.

- ▶ **Macro economy.** A fall in Chinese GDP growth to 5 percent or lower would have an adverse impact on per capital disposable income, which in turn could negatively affect the demand for non-essentials such as automobiles, wearable devices and connected home devices. As a result, GWP in these sectors would fall
- ▶ **Regulation.** In general, the CIRC has been supportive of innovation but there are times when it has been too conservative. For instance, the regulator may put a limit on guaranteed return of universal life insurance distributed online. Online universal life was recently

stopped by the regulator (which is considered a temporary measure to curb increasing risk). In another case, we observed that the slow adoption of telematics is caused by the tariff set by the regulator even after the recent pricing reform of auto insurance. In another case of regulatory back-and-forth, smog travel insurance, which compensates travelers during bad weather caused by smog, has been stopped by the regulator

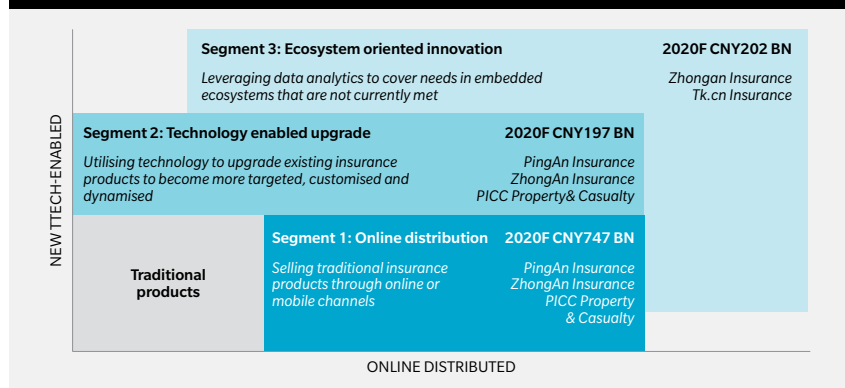
- ▶ **Technology.** Future development of technologies such as big data, cloud computing, block chain and artificial intelligence are critical to Insuretech. Therefore, technological failures of particular platforms can pose risks for companies, particularly when they are looking to ramp-up operations
- ▶ **Competition.** The two kinds of players that currently dominate the industry are traditional insurers and disruptors. Traditional insurers may set up joint ventures with tech companies to compete with disruptors, or set up subsidiaries to attack this market. New players could also emerge, increasing competition. For example, auto or 3C (computer, communication and consumer electronics) manufacturers could set up insurance companies to insure their own products. Similarly, peer-to-peer insurers may rise to cover online communities and large ecosystems might also self-insure

Notwithstanding these uncertainties and possible risks, the prospects of the Insuretech industry in China look bright, with the forecasts clearly suggesting a growing opportunity set for businesses in this space. Whether it exceeds, meets or fails expectations—only time will tell.

This article first appeared on BRINK on November 7, 2016.

FIGURE 1 CHINA INSURETECH SEGMENTS, KEY PLAYERS AND MARKET SIZE FORECAST BY 2020

Source: Oliver Wyman analysis



WILL COMMON GROUND BETWEEN THE US AND CHINA STRENGTHEN THEIR BOND?

Knowledge@Wharton



China's transition from an export-led economy to one based on domestic consumption is a leading global economic theme today, given the outsized importance of the country's economy. But many bumps are expected along the way in that huge changeover, even if things were to go relatively well.

Some areas of contention with trading partners like the US will continue to include differences over the valuation of the renminbi and export policies by companies with state control and funding. One example: new concerns about steel manufacturing overcapacity, which led China's steel exports to surge by 20 percent in 2015 and the underpricing of production elsewhere. Such a development caused critics to question just how rapidly China plans to abandon what many critics see as beggar-thy-neighbor policies.

Despite such frictions, there are positive developments too.

On March 31, President Barack Obama met with Chinese President Xi Jinping during a nuclear security summit for 50 world leaders in Washington. That meeting led to agreements for more cooperation in the areas of nuclear weapons, cybersecurity and climate change, according to news reports. On the business side, the two leaders also agreed to continue work on a bilateral investment treaty.

It is clear that with China and the US positioned to be the world's top growth engines in the decades ahead, the whole world has a stake in their relationship. If the two countries can focus more on what they have in common, rather than differences, they could deepen their bonds, according to Geoffrey Garrett, Wharton's dean and also a management professor who spoke at Wharton's annual E-House Real Estate Forum.

A new age is dawning in the economic relationship between

With China and the US positioned to be the world's top growth engines, the world has a stake in their relationship.

the United States and China, one in which the two countries are motivated by shared challenges and mutual needs, he noted. This bilateral relationship, a marked contrast to the “co-dependent” one that the two countries maintained for many years, has implications that extend far beyond the two nations’ borders. “The business interactions, the people-to-people interactions between the world’s two most important countries are going to be the win/win/win of the 21st century,” said Garrett.

Although China’s steep growth curve may be flattening – a good thing for China, according to Garrett – China is nevertheless expected to surpass the US as the world’s largest economy within the next 10 years. “Together, China and the US will be the twin growth engines of the global economy,” noted Garrett. The only country that has any real chance of catching up is India, whose status with regard to economic transformation he likened to that of China in the 1980s.

The similarities between the economies of China and the US are far greater than size and influence, a fact that is often not recognised. “The fundamental economic challenges facing the US and China are quite similar, though they play out differently,” said Garrett, who spoke about how the two countries are dealing with aging populations, public debt, infrastructure, productivity and the environment. In the US, the graying of society has profound implications for Social Security and Medicare, the two largest public programs for retirees and plays into people’s concerns about the programs’ future viability. The consequences of demographics in China are different: Having seen a peak in its working-age population, China must find sufficient

labour-market growth to drive its economy forward.

Also, China is experiencing the transition from family-provided care for the elderly to more state-provided care. This is unfamiliar territory for the Chinese, and is thought to be a driving force behind their high personal savings rates. “People believe that they are saving not only for their retirement but for their family’s,” noted Garrett.

Public debt tied to the financial crisis of 2008 is an issue for both the US and China. The US – and other Western countries – spent trillions on fiscal stimulus in the wake of the financial crisis. “There is a large overhang from these policies,” said Garrett, pointing out that public debt in the US has doubled from its pre-crisis levels, arguably at the worst time because of the financial pressures caused by the aging population. Garrett characterised public debt as “a kind of stealth candidate” in the US Presidential election, as it sparks concern among candidates and voters of all political stripes.

While in the US the public debt is a concern at the federal level, China’s heavy post-crisis spending on infrastructure has left many second- and third-tier cities saddled with heavy debts. Though there is no question that there were benefits from the investment in infrastructure, there remains the concern that Beijing may have to bail out provincial and local governments.

Indeed, infrastructure and public debt are closely linked in both the US and China. China’s infrastructure is new and modern, but building isn’t done. “The challenge for China is how does it continue the infrastructure revolution to move another 200 or 300 million

people to cities,” said Garrett. “Urbanisation is how hundreds of millions of Chinese people have been lifted out of poverty.” The absence of infrastructure in places such as India and Indonesia is the single biggest impediment to their ability to make similar strides, he said. In the US, the infrastructure challenge is about replacing an aging infrastructure when public debt is weighing heavily on the country.

Slowing productivity growth has made innovation and entrepreneurship the “number one agenda item” around the world, according to Garrett, because people believe that new organisations are better at producing innovation than mature ones. For its part, China’s new five-year plan has supply-side structural reform as its key element – an indication that the Chinese government knows that its next stage of economic growth will have to be driven by private sector innovation and entrepreneurship rather than by the government.

In the US, there is plenty of innovation and productivity. The issue is how they are concentrated by geography and company, and consequently the number of people who benefit. “There is a tiny number of people who live in the key innovation cities in the US: New York for finance, Hollywood for entertainment, San Francisco for information technology,” Garrett said. Apple is considered the most productive company in the world when measured by revenues per employee. “For shareholders that is great. But for the country the problem is Apple doesn’t employ very many people.”

Finally, the environment is a major concern in both countries, with China taking a highly pragmatic view that is spurring it to action. “They are finding domestic solutions

to domestic problems,” said Garrett. “Chinese entrepreneurs have figured out there are a lot of great business opportunities in China with regard to the environment, which is good for China and good for the world.” By contrast, in the US, the environment is what Garrett characterised as “a political football,” with the result being that the US has under-delivered in addressing climate change because there has been no political incentive to do otherwise.

FROM CO-DEPENDENT TO BILATERAL

These commonalities can deepen the bond between China and the US. Garrett characterised the relationship between China and the US from 1995 to 2005 as a “co-dependent” one: China lent the US money; the US bought Chinese goods. “The US became addicted to cheap Chinese loans and the Chinese economy was addicted to the US buying. It was co-dependent, addictive, and profoundly imbalanced,” he said, pointing out that China held some \$3 trillion in foreign reserves and that the trade deficit is over \$300 billion a year. It was also unsustainable.

He said the new economic relationship began when China allowed the renminbi to appreciate against the dollar. Over the last decade, it has appreciated 30 percent in nominal terms, 50 percent in real terms. A defining characteristic of this new relationship is the importance of China’s consumer market to the US economy, as illustrated through the fall and rise of General Motors.

The US automaker went bankrupt after the financial crisis and was bailed out by the US government. But it returned to profitability thanks to robust demand from China. GM now sells more vehicles in China than it does in the US. “Ten years ago we thought about China as a cheap place to make cars, but now it’s the biggest growth market for selling them,” said Garrett.

The growth of the Chinese consumer market is critical to many US firms, even though products designed in the US that are made and sold overseas don’t show up as exports. The benefits to employees and shareholders of such companies are obvious, but explaining to the American public that it is good for the US if the Chinese consumer buys American products made in China is politically challenging.

Garrett pointed out that the US faced a similar situation some 30 years ago with Japan: The US pushed Japan to increase the value of the yen against the dollar, resulting in increased Japanese investment in the US. Acceptance of Japanese investment in the US was slow. It was helped by Japan’s economic downturn, which meant Japan was no longer seen as an economic threat, and by Japan’s status as a US security ally.

The US is likely now to see more and more Chinese investment, too, but acceptance could be slower than it was for the Japanese. For their part, Chinese investors have been savvy, focusing largely on real estate rather than “big, glamorous” transactions involving companies. Eventually, there will be more acquisitions of US companies by China. “This is the reality that the US has to accept,” asserted Garrett. “The good news about this relationship is that it

is a win-win. The bad news is it doesn’t work easily politically.”

One solution, noted Garrett, would be to have China and the US participate on equal footing in more trade and economic organisations. Garrett characterised the Asia-Pacific Economic Cooperation, to which both China and the US belong, as being about “photo opportunities.” Among US-led organisations where China is not a member is the Trans Pacific Partnership.

China’s absence is particularly notable because other TPP members trade with China. It has been suggested that the US would like to see China follow the same path to the TPP as it did to the WTO: The US lays down the rules and China joins once the rules have been established. But “China has grown so much that it doesn’t make sense now for it to follow that same path,” he said. Meanwhile, the RCEP – or Regional Comprehensive Economic Partnership, the proposed free trade agreement between ASEAN and other countries – would not include the US.

“A real trade agreement that includes China and the US is in everyone’s interest,” said Garrett. Paraphrasing former US Secretary of State Henry Kissinger, Garrett said such an agreement between the world’s two largest economies would create peace and prosperity in the 21st century – and be a win for China, a win for the US and a win for the world.

This article first appeared in Knowledge@Wharton, which is the online research and business analysis journal of the Wharton School of the University of Pennsylvania and on BRINK on April 22, 2016.

BEWARE THE DRAGON: THE GLOBAL IMPACT OF A CHINA HARD LANDING

Jamie Thompson

Head of Macro Scenarios for Oxford Economics



Risks to the global economy are rising, according to the vast majority of businesses queried in the recent Oxford Economics Global Risk Survey. Meanwhile, 25 percent of respondents believe that a global downturn or recession is more likely than not.

But the most remarkable result from the survey – which polled some of the world's largest companies – is the feared trigger for weakness in the global economy: Almost all respondents cite the Chinese economy among their top concerns.

CHINA'S GLOBAL LINKS RUN DEEP

The perceived importance of China to businesses across the globe is perhaps unsurprising. Its connections to other countries

are complex and increasingly powerful. Consider first the impact of China on global commodity markets, given the commodity-intensive nature of the country's investment-led growth. Against the backdrop of continued strong oil production, increased fears over Chinese prospects have already been associated with major falls in oil and other commodity prices.

While weaker oil prices have traditionally been viewed as a net positive for the global economy – the boost to spending among net energy importers has generally outweighed weakness among net energy exporters – recent history suggests a more nuanced picture at current low oil price levels. Continued falls in oil prices have left some producers in a particularly challenging position. In Saudi Arabia, for example, the government

recently unveiled a potentially radical fiscal consolidation program in its 2016 budget.

Expected gains for some net energy importers have also disappointed. In the United States, the domestic energy sector has dragged heavily on both capital expenditure and payroll growth, in part reflecting the behaviour of shale oil firms. Indeed, as oil prices have plunged, so has capital expenditure in the US oil and gas extraction sector. The drag on the US economy has been material, with the investment fall knocking 0.4 percentage points off annual growth in 2015.

The significance of China for trade is also unquestionable. China has surpassed the US and the EU as the main export destination for its Asian neighbours. And some of the most reliant on China are commodity producers, leaving them doubly exposed to a weaker Chinese economy.

In addition, severe Chinese weakness would most likely be accompanied by a shock to confidence in the global real economy. That would affect not just countries or businesses with significant direct exposure to China; as the global economy slowed, investment plans would be scaled back more generally, accompanied by slackening household spending.

Finally, recent market turbulence has highlighted a number of other key channels. A sharp China slowdown would undoubtedly challenge investor sentiment, sparking major shifts in exchange

rates, interest rates and an array of other asset prices – with important implications for not only growth in different countries, but also the stance of monetary policy across the globe.

WHAT HAPPENS IN CHINA DOES NOT STAY IN CHINA

In a qualitative sense, then, Chinese developments matter. But, quantitatively, how great would the fallout be from a severe China slowdown?

In recent research, my colleague Alessandro Theiss and I sought to answer this question. In particular, we modelled a “hard landing” involving Chinese growth of just 2.5 percent in 2016. That lies far below our central forecast of a limited slowdown and the probability of such a disappointing growth performance is not high. But, should it materialise, the implications for the global economy would be profound.

In the hard landing, global prospects deteriorate as emerging markets and commodity producers sink deeper. But advanced economies are not immune. By 2017, five advanced economies have fallen into recession, and relative to our central forecast, more than 2 percent will be shaved from the world’s total GDP.

Not many can cushion the blow. In a number of advanced economies, monetary policy rates may already be close to their effective floor, even where that floor is negative. In certain emerging market economies, policy is constrained by concerns over sharp capital outflows, depreciation and inflationary pressures. Of the 46 countries we analysed, only half are able to provide a policy rate response.

The US would be one of the least affected economies in a China hard landing; however, it is by no means immune. On the trade side, China accounts for just 7 percent of US merchandise exports. But emerging markets, which are more directly exposed to Chinese weakness, are responsible for around a third, even excluding Mexico. That is not to mention other linkages from China to the US economy, through capital flows, exchange rates, commodities, confidence and more.

Ahead of the Federal Reserve’s December policy rate hike, I remarked on the potential for a China hard landing to undermine the Federal Reserve’s plans to steadily increase interest rates in 2016 and beyond. If such an event were to unfold, I argued, the first rate rise in the nascent Fed policy-tightening cycle would also – for a while at least – be the last. As events of recent weeks have borne out, that remains very much the case.

A China slowdown matters. A hard landing would have a profound effect on the global economy.

BEWARE THE DRAGON?

In short, there is little doubt that a China slowdown matters. A hard landing would have a profound effect on the global economy. It would weigh heavily on emerging markets and advanced economies would not be immune.

But the precise scale of these impacts is uncertain. Pessimists, for example, might conceive of a more extreme China hard landing scenario or a more moderate slowdown accompanied by a series of other blows to the global economy.

Equally, optimists can point to the possibility that a far greater policy response would greet a major

shock to Chinese activity. In China, the authorities might seek to counterbalance the slowdown more actively through expansionary fiscal measures and encouraging greater bank lending. Elsewhere, additional unconventional measures could be countenanced by various central banks across the world.

Moreover, it is important to place this risk in context. While we have anticipated a China slowdown for some time, our central expectation is that further slowing will be relatively limited. The risks to Chinese growth are substantial – but there may be fire in the dragon just yet.

This article appeared on BRINK on February 17, 2016.

CHINA'S RISE: THE AIIB AND THE "ONE BELT, ONE ROAD"

David Dollar

Senior Fellow with the Foreign Policy and Global Economy and Development for the Brookings Institution



China's six years of breakneck growth leading up to 2007 were accompanied by a rising trade surplus. But when that surplus fell sharply after the global crisis, Chinese authorities made up for the shortfall of demand with an increase in investment. Today, China is using a lot more investment to fuel slower growth than in the past: The real-world result of this falling capital productivity has been empty apartment buildings, unused airports and serious excess capacity in manufacturing. Meanwhile, consumption is very low, especially household consumption.

One response China has taken to this changing growth dynamic is to try to spur external demand for Chinese investment, specifically for major infrastructure projects. The other response has been internal: To initiate reforms that rebalance its economy from investment to consumption.

The latter effort has a better chance of success than the former.

SPURRING INVESTMENT – BUT NOT ENOUGH

It is no coincidence that this period of excess capacity at home is the moment at which China launched expensive new initiatives, such as the Asian Infrastructure Investment Bank (AIIB), the BRICS Bank and the "One Belt, One Road" initiative in order to strengthen infrastructure both on the westward land route from China through Central Asia and on the southerly maritime routes from China through Southeast Asia.

Developing countries understand the purpose for the AIIB: Many have moved away from using the existing multilateral infrastructure investment banks because they are so slow and bureaucratic. The US made a mild effort to dissuade some

Changing the incentives of local Chinese officials to align with fiscal rebalancing is a key institutional reform.

allies from joining the AIIB, fearing China would use it for narrow political or economic ends. But a diverse group of nearly 60 countries has signed up, making it difficult for China to use the bank to show favoritism in financing projects. In fact, the AIIB should be viewed as complementary to – and not competitive with – America’s own main economic initiative in the Asia-Pacific, the Trans-Pacific Partnership trade agreement.

But the AIIB will be too small to make a dent in China’s excess capacity problem. If the AIIB is very successful, then in five years it might lend \$20 billion per year, comparable with the World Bank’s International Bank for Reconstruction and Development. But China would need \$60 billion per year of extra demand to absorb excess capacity in the steel sector alone.

The “One Belt, One Road” initiative is larger than the AIIB. It started with the idea that nearby countries in Central Asia could benefit from more transport infrastructure, some of which China could finance bilaterally. However, the economies of Central Asia are not that large, and the potential for investment is limited. For that reason, China added the idea of a maritime “road.”

Because “One Belt, One Road” will be implemented bilaterally between China and different partners, it may seem that there is more potential for China to use this initiative to vent some of its surplus. But I still doubt that this will be on a scale to make a macroeconomic difference for China.

Among the various developing countries along “One Belt,

One Road” routes, there are some with relatively strong governance – India, Indonesia and Vietnam, for example – that will be hard for China to push around. Those countries will not want to accept large numbers of Chinese workers or take on large amounts of debt relative to their GDP. On the other hand, there are weak governance countries – Cambodia and Pakistan, for instance. It may be more feasible for China to send some of its surplus production to these countries, but there is a reasonable prospect that in the long run, China will not be paid.

DOMESTIC ROADS TO REFORM

Domestic reform is a much more promising road to deal with China’s surplus problem, and to rebalance its economy away from such a heavy reliance on investment. The resolution that came out of the Third Plenum in November 2013 sketched out dozens, if not hundreds, of reforms. The ones that are likely to have the greatest effect are the household registration system (hukou), intergovernmental fiscal reform and financial liberalisation, opening up China’s service sectors to competition.

Under hukou, 62 percent of the population is registered as rural residents, and it has been difficult for them to change this designation. Rural migrants to the cities cannot bring their families or truly become citizens of the cities. Reforming the system would help reallocate labour from low productivity (farming) to higher productivity (urban manufacturing and service employment) activities. But local

governments worry that they will lack the resources to fund greater social services for migrant families.

China’s Ministry of Finance has announced general plans for fiscal reform to support rebalancing. First are measures to bolster local government revenue, potentially including a nationwide property tax. Second is to collect more dividends from its state enterprises. If this happens at both the local and the central level, it would reduce some of the bias towards investment and help ensure resources for government services. Third is to allow municipalities to issue bonds to fund their infrastructure projects, rather than relying on shorter-term bank loans.

The final aspect of fiscal reform may be the hardest: Local officials are generally rewarded for their ability to provide investment and growth. While the system has been successful at that, it has been less successful at meeting other objectives, such as clean air, food safety and high-quality education and health services. Changing the incentives of local officials to align with rebalancing is a key institutional reform.

LIBERALISING CHINA’S FINANCES

China’s repressed financial system is a third area of reform. Real interest rates that are close to zero amount to both a tax on household savers and a subsidy to investment by firms and local governments able to borrow from the banking system. Almost everywhere in the world has had zero real interest rates in recent years,

but in China, they go back more than a decade. The government has taken some initial steps to raise deposit and lending rates, as well as to allow a shadow banking system to develop with better returns to savers and higher-rate loans to riskier clients.

The problem with the current arrangement is that most shadow-banking wealth products are marketed by commercial banks and treated as low-risk by households. Total shadow banking lending has grown at an explosive rate in recent years and, not surprisingly, some of the funded investments are starting to go bad. The first corporate bond default occurred last year, and that result should help ease the moral hazard that has built up in the system. The announcement of the formal introduction of deposit insurance this year is another important step in the separation of a cautious commercial banking sector from a risky shadow-banking sector. Central Bank Governor Zhou Xiaochuan recently announced that interest rate liberalisation would be completed within one to two years.

Recent moves to liberalise the bond and stock markets so that private firms can more easily go to the capital markets are also in the right direction, as are moves to increase the flexibility of the exchange rate. The IMF assesses that China's exchange rate has gone from "substantial undervaluation" to "fairly valued" in recent years, so it should not be too difficult for the authorities to reduce their intervention and allow a more market-determined rate. Finally, opening up the capital account should be the last step in financial liberalisation.

OPENING SERVICE SECTOR TO COMPETITION

A final area of reform is to open up China's service sectors to competition from private firms and the international market. The modern service sectors are the domain in which state-owned enterprises continue to be dominant, including financial services, telecom, media and logistics. The rebalancing from investment toward consumption means that, on the production side, industry will grow less rapidly than in the past while the service sectors expand. China will need more productivity growth in the service sectors, which is hard to achieve in a protected environment.

For other developing countries, successful rebalancing in China will create both challenges and opportunities. While China's appetite for commodities is likely to moderate, rebalancing should lead to a rise in its demand for manufactures and services from other developing countries. And China is rapidly emerging as a major source of foreign direct investment. A world without Chinese rebalancing, by contrast, is likely to be more volatile.

A more in-depth version of this piece appears on the Brookings site and was condensed from a paper titled, "China's rise as a regional and global power: The AIIB and the 'one belt, one road,'" which was released in Summer 2015.

This article appeared on BRINK on April 27, 2016.

DEVELOPING A BLUE ECONOMY IN CHINA AND THE UNITED STATES

Michael Conathan

Director of Ocean Policy at Center for American Progress

Scott Moore

International Affairs Fellow at Council on Foreign Relations



As the world population balloons toward more than 9 billion people by 2050, nations will need new resources from a finite amount of space to meet soaring demand. And as more people move to coastal regions, their minds will inevitably be drawn to the sea. After all, more than two-thirds of our planet is covered with ocean, and the seas boast tremendous economic development, transportation corridors, sources of oil and gas, and cornucopias of seafood.

Oceans also provide less-tangible benefits that are often difficult to quantify, including moderating the planet's climate by absorbing roughly 90 percent of the heat trapped by

a thickening atmospheric blanket of carbon pollution. They produce more than half of the oxygen we breathe. In coastal regions, healthy coral reefs and other wetlands ecosystems safeguard communities from storm surges and flooding events, sequester massive amounts of carbon, and filter out other pollution produced on land.

To sustain a 21st century population boom, we must balance marine economic development with protection of the ocean's environmental services that have sustained life on our planet for millions of years. This report examines the different ways that two nations, China and the United States,

are approaching this dilemma by promoting a concept known as the "Blue Economy."

The Blue Economy represents a relatively new manner of describing ocean economic development that began to emerge first among many island nations, including tiny developing countries such as the Republic of Seychelles, as well as the archipelagic giant Indonesia, the fourth-most-populous country in the world. It's now gaining recognition in some of the world's biggest and most powerful nations, including China and the United States, which have increasingly begun to turn to the concept of the Blue Economy to promote development of their ample ocean and coastal resources. Honing the Blue Economy's focus could ultimately pay dividends by allowing economic growth to blossom alongside environmental sustainability.

China has not typically been at the top of the list of countries that rely most heavily on their ocean resources. Its exclusive economic zone, or EEZ – the area of ocean space over which a nation has sole right to extract resources including minerals and fish – is the subject of ongoing debate, with China claiming a vast area of the South China Sea that neighbouring countries also claim. But China has sought to expand the economic contributions it receives from offshore resources.

The United States, which boasts the largest EEZ in the world, has also looked beyond its shores to support its economy. Given both nations' economic clout, the United States and China have tremendous potential to develop and implement policies that promote marine environmental protection and to prove that these strategies do not preclude the possibility of economic growth.

Yet as the Blue Economy emerges as a means of quantifying the economic benefit of ocean industries and resources, its true definition remains opaque. Adding up the contributions of all economic activity related to ocean and coastal ecosystems is a relatively simple means of drawing boundaries. But it fails to account for the reality that industrial development frequently comes with an environmental cost.

Offshore fossil-fuel extraction, for example, carries the risk of spills, which lead to the degradation of natural resources, and will increase emissions of carbon pollution and other greenhouse gases. In other cases, promoting one industry means preventing another; for example, an area designated for shipping lanes would be off-limits to construction of an offshore wind farm. As a result, the ocean economy cannot simply be re-labelled the Blue Economy. The world needs a new definition of what constitutes a Blue Economy both in order to promote the economic benefits of ocean industries and to ensure sustainable development.

In January 2014, developing nations came together for two days in Abu Dhabi to explore and develop the concept of the Blue Economy under the auspices of the UN Sustainable Development Knowledge Platform. Their efforts were based on a concept paper that established the Blue Economy as a "framework for sustainable development." It explained that "at the core of the Blue Economy concept is the de-coupling of socioeconomic development from environmental degradation...founded upon the assessment and incorporation of the real value of the natural (blue) capital into all aspects of economic activity."

According to international law, countries have sole economic jurisdiction over ocean space that extends 200 nautical miles out from their shores. Small-island developing states have embraced the concept of the Blue Economy as a means of maximising the benefits that accrue from their greatest asset: their marine resources. The Seychelles, for example, has a land area of 455 square kilometres, or 175 square miles – roughly three times the size of the District of Columbia. Yet it has dominion over an EEZ that encompasses more than 1.3 million square kilometres, or more than 514,000 square miles – nearly twice as large as Texas.

While island nations clearly have much to gain from improved management of their ocean resources, so do larger coastal nations, including the two economic leviathans: the United States and

To sustain a 21st century population boom, we must balance marine economic development with protection of the ocean.

China. In both nations, efforts are underway to better understand, define, and promote the Blue Economy. This report explores the concept's development, detailing the similarities and differences, and makes recommendations for how the United States and China can promote a collaborative understanding of how to value the ocean's natural resources around the globe.

This report also proposes three key recommendations to help the United States and China account for the true value of robust marine natural resources and to boost cooperation as they increasingly look to their offshore regions for economic growth.

Specifically, the United States and China should:

- ▶ Jointly develop a methodology to account for the long-term economic contributions of healthy coastal and ocean ecosystems

- ▶ Establish joint initiatives under the US Department of State's EcoPartnerships program, incorporating ocean planning and Blue Technology clusters
- ▶ Enhance and expand existing bilateral partnerships and develop new agreements to ensure sharing of best practices and consistency of oceanographic data collection and dissemination

Leaders in both China and the United States understand the need to boost economic growth, while curbing environmental degradation and reducing carbon pollution and other emissions that fuel climate change. Now, it's time for them to turn their attention to their vast areas of ocean space and implement policies that acknowledge the true economic and environmental opportunities that exist offshore.

This article first appeared on the Centre for American Progress blog and BRINK on July 20, 2015.

DEBT, NOT RESERVES, TO CONSTRAIN CHINA'S CROSS-BORDER BUYING SPREE

Alicia García Herrero

Senior Fellow for BRUEGEL and Chief Economist for Asia Pacific at Natixis



Despite an \$800 billion drain on China's foreign reserves over the last 20 months, Chinese firms have been on a buying spree that has only accelerated since the beginning of the year.

One could argue that the Chinese government may have to start rethinking its "go-out" policy for Chinese companies to preserve the country's hard-earned foreign currency assets, accumulated after years of an export-led growth strategy; however, the reality is that the first quarter of 2016 has seen an explosion of cross-border mergers and acquisitions by Chinese companies. In one single operation, the state-owned ChemChina offered up to \$43 billion to acquire Syngenta, the Swiss agrochemical firm.

China's total M&A activity during the first quarter could be close to \$100 billion – about the same as in 2015 – according to Dealogic, one of the largest M&A data providers. That figure is bigger than the \$60 billion estimated by the advisory firm, Rhodium Group and more than double the official \$40 billion, published by China's Ministry of Commerce.

There's been a lot of speculation about why Chinese firms are stepping up their purchases. The first and most structural one is that the Chinese economy today is much larger compared with its presence in the global M&A landscape. In fact, China's GDP is at least 14 percent of the global economy, while its share in total cross-border M&A lies

Big question:
How are Chinese
firms financing
their cross-
border M&A
buying sprees?

between 2 and 6 percent, depending on the source.

Beyond the structural reasons pushing for a bigger part of the pie, more cyclical reasons could be behind the recent acceleration in China's cross-border M&A, such as the disenchantment with domestic investment opportunities after the stock market crash last summer, as well as increasingly low interest rates. Very low rates make the domestic financing of such large M&A operations much less costly; that coupled with the widespread expectation of a yuan devaluation – at least until very recently – may have heightened the interest of Chinese CFOs for cross-border purchases.

HOW ARE CHINESE FIRMS FINANCING M&A

A key question to ask in order to understand whether this buying spree can continue and, even more importantly, how sustainable it may be, is how this cross-border M&A activity is being financed. In that regard, many observers remain perplexed by the timing of such a big surge in M&A, as it coincides with further tightening of controls on capital outflows in China in an effort to stem the rapid loss of reserves.

One could actually argue that, in normal times, reducing the amount of low-yielding foreign reserves to buy real assets abroad would have been considered a great idea and is probably one of the key reasons for China's "outward policy." The problem is that, since last summer,

China's financial woes have radically changed the perception of how many reserves China can lose without creating a "confidence" problem. The question, then, is whether China's recent boost in cross-border M&A could be constrained by trends in China's foreign reserves or, more specifically, whether M&A activity may decelerate, or even stop, if foreign reserves were to fall again in as rapid a way.

While such a scenario is appealing on paper, the reality is that the relation between the boost in M&A and the fall in reserves is more blurred than one might think. In fact, only a small part of the loss of reserves can really be explained by such purchases.

To give a rough sense of dimension, given data limitations, China cross-border M&A in 2015 was only \$40 billion, according to official data, as compared to \$513 billion foreign reserves lost in 2015. Furthermore, part of that amount cannot have dragged down foreign reserves, as the M&A operations were either financed offshore or even paid in yuan as part of China's efforts to internationalise the currency. Regarding the former, according to the Ministry of Commerce, as much as 16 percent (\$6.3 billion) of China's M&A in 2015 was financed offshore. As for the latter, the People's Bank of China has estimated that as much as 16 percent of total Chinese outward foreign direct investment was denominated in yuan in 2014. Assuming that such a trend did not change much in 2015, only \$27 billion (i.e. 68 percent of total cross-border M&A) would have eaten up China's foreign reserves.

This is about 5 percent of the total fall in foreign reserves in 2015. Even if we were to use the upper estimate on China's cross border M&A for 2015 from Dealogic, it would still only be 13 percent of the total reserves.

While large, it seems quite clear that cross-border M&A is not driving China's loss of foreign reserves, so it is hard to think of reserves as a key constraint for China's buying spree to stop any time soon.

Such a constraint might actually be elsewhere, namely in the increasingly high leverage of Chinese firms. In fact, there used to be a time when Chinese companies were cash-rich, as credit was limited. Nowadays, after a long cycle of easy money since 2008, Chinese firms have doubled their debt-to-GDP ratios while they have severely reduced their repayment capacity. A simple measure of such capacity, EBITDA to interest payments, has worsened dramatically in the last few years and is now half of that of companies globally. This is due not only to the sharp slowdown in corporate revenue in China, but also to the rapid growth in their interest burden as they continue to grow. Large foreign purchases by Chinese companies only add more fuel to the fire.

All in all, it seems that the real limit for China's buying spree abroad may lie on the amount of their increasing leverage, rather than on the country's recent fall in foreign reserves.

This article appeared on BRINK on April 26, 2016.

IS IT “DEJA VU ALL OVER AGAIN” FOR CHINA’S FINANCIAL WELL-BEING?

Jack Rodman

Senior Advisor for Crosswater Realty Advisors



Even to long time China watchers, the start of 2016 has further confused and exacerbated an already complex outlook for the country’s short-term recovery to the economic slowdown.

While there is a lot to be said about issues confronting China today, here are four of the most complex and pressing:

Ever-increasing nonperforming loans in China’s financial sector and how to manage them effectively, at the same time re-capitalising China’s largest banks.

China’s looming currency crisis, contributing to a massive outflow of capital (approaching \$1 trillion) over the past year.

Reviving the Chinese residential real estate market, suffering from years of reckless building in third to fourth tier cities and “out-of-

control” residential real estate prices in China’s largest cities.

Tying this all together is China’s efforts to reform state-owned (zombie) industries that are a drag on the economy and could trigger a collapse of the shadow banking system and systemic risk to the financial system, as losses will directly impact bank profitability and capital adequacy.

In addition, it will take a generation to shift from an export-led economy to a consumption-driven economy as China slowly moves away from the one-child policy and tries to provide its aging citizens some form of safety net.

CHINA’S “BACK TO THE FUTURE” POLICY MOVES

Back in 1999, when about 45 percent of every loan in China

China can’t “kick the can” of its financial problems down the road forever.

was considered a nonperforming loan, China recapitalised the banking system and created Asset Management Companies with the sole purpose of removing the bad loans from the banking system (enabling the banks to go public and raise capital) and resolving them through debt-to-equity swaps, restructuring, collection at discounted prices and finally, sale to foreign investors. While the goal was sound, its implementation was a failure. The banks went back to making bad loans (many policy-directed) and stopped “reporting” on bad loans for almost a decade, resulting in the bad loan mess they are facing today.

The debt-to-equity swaps were totally ineffective as two state-owned enterprises faced off: the banks vs. the borrowers. The borrowers had no intent of paying back their bad loans, as they took the loans as part of the government’s policy of full employment, and the banks, which were “bad creditors,” were now asked to be competent stewards of “equity shares” of zombie companies they could not control, nor were they willing to lend them more money. This dilemma, conflicting goals and commitment to financial reforms inadvertently led to the creation of wealth and trust management products, sold through the banks that provided short-term loans to China’s most cash-strapped borrowers, who were in dire need of liquidity to survive.

Wealth management products (WMPs) grew furiously as the government’s efforts to make homeownership more affordable forced speculators out of the housing markets (which has been a driving force in China’s economy,

contributing as much as 20 percent of GDP for more than a decade) and into investing in WMPs and trust products offering (annualised) interest rates of 20-30 percent on very short (less than one year) maturities. As much as \$4 trillion was raised in this manner in a concentrated period of time. Most of the capital went to undercapitalised real estate developers and small-to medium-sized businesses that could not borrow from the large state-controlled banks.

Today, much of the current and pending increase in nonperforming loans is coming from the real estate industry, which was over-extended in third- and fourth-tier markets and inefficient SMEs and state-owned businesses that were deemed “uncreditworthy” by China’s largest banks.

Presently, we have multiple sectors contributing to nonperforming loans resulting from defaulting WMPs and trust products that were “sold through the banks to their wealthiest customers,” real estate developers that were forced to borrow at usurious interest rates to stay alive and thousands of SMEs and state-owned companies that were kept “solvent” by China’s export-driven economy and infrastructure spending.

China is trying to find a way out of this by taking a page from the failed 1999 playbook and planning another wave of debt-to-equity swaps in addition to securitising bad loans and selling them intra-bank as securities to the banking system. Its alchemy is brilliant. Yesterday, it was a bad loan; now, it is packaged as a “security” that the banks are forced to buy.

HOW LONG CAN CHINA JUST “KICK THE CAN” OF FINANCIAL PROBLEMS DOWN THE ROAD?

I believe China’s policy makers might want to read about the global financial crisis and the role of Lehman Brothers and other large financial institutions to figure out that they cannot “kick the can” down the road forever. At some point, losses in the financial system will have to be crystallised and marked to market, which will once again require a massive recapitalisation of the banking sector.

As previously mentioned, China is struggling to accomplish two impossible feats previously attempted and failed by many governments.

In wake of the Chinese stock market bubble and a drop in the Shanghai and Shenzhen indices of 40 to 60 percent, the government attempted to prop up share prices, which is tantamount to catching a falling sword. Ask the Bank of Japan how successful it was in trying to rescue the Nikkei 225. China’s efforts to date are approaching \$1 trillion.

The slowing economy and increasing defaults in WMPs and trust products, combined with a pending property bubble, is causing many Chinese capitalists who profited from two decades of economic growth to begin moving their capital holdings offshore. These moves were made seeking safety and stability, as well as higher rates of return, as China intentionally devalues its currency to make its export-driven markets more attractive. Most of the capital flight moves through Hong Kong;

don't be surprised to read about how much capital was moved to offshore accounts as more disclosure comes to light from the Panama Papers leak.

The massive outflow of capital from China saw a brief hiatus in February after more than \$1 trillion had moved offshore. Much of the slight gain in foreign exchange reserves was attributed to Chinese holdings of Japanese Yen and the Euro, both showing renewed strength.

The coup de grâce is that a major goal of President Xi's policies has been to root out corruption. This has had a

profound impact on state and local governments that directed the land sales programs, in which bribery and corruption is endemic.

China cracked down on money laundering as well as common mechanisms to move capital offshore through debit cards in Hong Kong and life insurance products, which accomplished the same objective.

In the US real estate market, we see the effect with capital inflows from the EB-5 visa program, whereby an investment of \$500,000 buys you a green card. I think we sold

our citizenship pretty cheap. More troubling is the impact that China is having on both US and Canadian residential markets that are once again grossly out of balance with the affordability index of median home prices to median incomes. China created its own housing bubble in China and now it appears that they are going to export it to the US and Canada.

I, for one, can do without another global financial crisis.

This article appeared on BRINK on April 25, 2016.

REAL AND IMAGINED RISKS OF CHINA'S SHADOW BANKING

Christian Edelmann

Global Head of Corporate and Institutional Banking for Oliver Wyman

Andrew Sheng

Distinguished Fellow at Fung Global Institute



Smart regulation will be key to the future of China's shadow banking sector.

With China recording its slowest economic growth last year since 1990, there is widespread concern about the country's financial system, with a particular focus on the fast-growing shadow banking sector as a potential source of instability. Shadow banking is not without risks, and targeted regulation can help mitigate risks throughout the sector. But, with proper management and safeguards, shadow banks can also play a valuable role by channelling funds to capital-starved sectors. Fears that it could destabilise China's economy – and economies throughout the world – are overplayed.

In 2013, China's shadow banking market amounted to approximately RMB 31 trillion (US\$5 trillion), equivalent to 54 percent of China's GDP. While this essentially doubled in relative size since 2009, when the sector was about 27 percent of GDP, the actual size of the country's shadow banking sector is often

exaggerated in the media. That's because traditional approaches to measuring the sector are skewed by counting some of the same exposures twice or even three times as credit risk is repackaged. Moreover, the sector is smaller, as a share of the economy, than what the Financial Stability Board found in the United States (where it's 84 percent of GDP) or the United Kingdom (177 percent of GDP).

THREE PRIMARY FACTORS HAVE DRIVEN THE SHADOW BANKING SECTOR'S GROWTH

First, China's economy is over-reliant on bank credit and lacking in developed capital markets. With the majority of the funding circulated within the banking system itself, there is a structural imbalance of equity versus debt in the financial system, which

has led the authorities to impose strict credit controls such as loan quotas and loan-to-deposit ratios. These regulations are major drivers behind the use of shadow banking by Chinese banks as a channel for off-balance-sheet credit provision.

Second, bank lending is significantly skewed towards state-owned enterprises and large corporates, whereas small-and-medium enterprises (SME) and retail clients find it challenging to access bank credit. While 99 percent of Chinese firms are SMEs, constituting 70 percent of employment, 60 percent of GDP, and 50 percent of tax revenue, they represent less than 20 percent of bank lending. So they have turned to the shadow banking sector for access to funding, often at high real rates.

Third, investors in China are severely restricted in their asset allocation and heavily exposed to bank deposits as their main investment avenue. Deposit returns are capped (with initial steps of liberalisation only happening most recently), increasingly driving investors to seek out opportunities to achieve more attractive real returns. These returns unfortunately carry hidden risks and moral hazard issues.

Shadow banking has also grown in tandem with the emergence of new digital-enabled players, such as peer-to-peer lenders and asset transfer platforms. Their growth is unfolding in an environment where e-commerce sales have surpassed the total sales of department store chains and supermarket chains in less than a decade. This has created a large group of young, increasingly wealthy and educated consumers

looking for convenient, transparent, informative investing/trading/financing platforms. Leading peer-to-peer players are tapping into this demand with convenient digital solutions and are ahead of the formal banking sector in the use of “big data” to judge the credit worthiness of potential borrowers.

But even with more sophisticated credit scoring, the shadow banking sector is not immune to non-performing loans. While such loans are a reality for all lending businesses, some analysts have expressed fears that China’s financial system could be adversely affected by a large number of shadow banking non-performing assets. Those fears are overblown. Chinese banks’ risk/NPL exposures are still contained, as banks’ direct and indirect exposures to shadow banking are still limited in size.

Financial modelling by Oliver Wyman reveals that even in a “disastrous” scenario, NPLs will “only” rise to 24 percent of the total value of loans in the shadow banking sector. Of these NPLs, some 22-44 percent entail exposures that may ultimately be borne by the formal banking system. As a result, under the worst case scenario, we estimate the increase in the NPL ratio for banks in the formal banking sector would be no more than 4.3 percent. While that is a sizeable increase, it is still manageable. In absolute terms, it is still smaller than what the Chinese state owned lenders cleared off their balance sheet between 1999 to 2005, and that process did not provoke any market turmoil or financial sector instability.

Smart regulation will be key to the future health and stability of

China’s shadow banking sector. One critical step will be to eliminate regulatory arbitrage. This can be achieved by redesigning the regulatory framework, with a focus on preventing risk mismatching of assets and liabilities as well as mislabelling, pushing for improved transparency and risk management on bank-related shadow banking products, and establishing a credit “firewall” between commercial banks and non-bank shadow banking activities.

Another important step will be closer monitoring and regulation, at the national level, of institutions providing credit insurance. And the non-bank lending business, which can be a healthy complement to the formal banking sector, needs to be brought under proper regulatory control while not killing the business model in itself.

While the issues in China’s shadow banking sector are still manageable, it behoves regulators and policymakers to pre-empt any escalation of shadow banking NPLs, which could have contagion effects. The current juncture represents an opportunity for a holistic solution to address the structural imbalances in the Chinese economy and financial system. This will ensure the financial system meets China’s changing funding requirements as its economy moves towards a middle class, urbanised consumption and production model that will be broadly based, technologically driven, mobile-Internet friendly, inclusive and ecologically sustainable.

This article was revised and updated on April 15, 2015. It appeared on BRINK on March 27, 2015.

CHINA'S AGING POPULATION PREPARES FOR TOMORROW

Julio Portalatin

President and CEO of Mercer



Ensuring people are prepared to thrive in the global workforce of the future is a top concern of most nations. Technology continues to rapidly shift skilled labour requirements, but social and demographic shifts are equally dramatic realities. The aging population raises the critical questions of continued workforce participation, retirement sufficiency and health care for this growing group. For China – the world's most populous nation and second largest economy – the issue calls for vision and action, especially in the face of the latest data.

For example, by the year 2050, China's older population – those over age 65 – will likely swell to 330 million, or nearly three times as many as now. Complementing this statistical reality is another one: A recent report from the

Chinese Academy of Social Sciences said the fertility rate in China is 1.4 children per woman, close to the global warning line of 1.3, the so-called "low fertility trap," or the point at which no country has been known to return to population replacement level. This is an even more concerning number because most experts believe Chinese data on this issue to be highly conservative.

It's no surprise then that only 6 percent of China's workers expect to receive income support from their children when they retire, as might have been traditionally expected, according to a study on East Asia retirement by the Global Aging Institute. Meanwhile, the global shift toward defined contribution pension plans further places the problem of retirement income adequacy – or, to put it another way, financial independence – in the hands of

China's older population – those over age 65 – will likely swell to 330 million by 2050.

individuals who are generally not well-equipped to manage the financial challenge just yet.

Indeed, the outcomes of tomorrow are absolutely determined by the actions taken today, although the answers are not simple. Nobel Laureate William Sharpe, a leading economist, in discussing retirement research – specifically, “decumulation,” or the conversion of pension assets accumulated during an employee’s working life into pension income to be spent during retirement – declared it “the hardest problem I’ve ever considered.” In China and other Asian nations, the focus is shifting from the accumulation of funds to the drawdown phase.

But that doesn’t mean there are no answers, and, in our increasingly interconnected world, we would do well to focus on the opportunities and solutions this presents. While there are few more significant issues in our lifetime than the aging population, I, for one, refuse to look at this as a “longevity catastrophe.” The fact that people are living longer is a positive thing, with upsides for consumer markets, and opportunities for older workers to contribute for longer, and in new and productive ways, to society.

In designing solutions, an important place to start is in looking at the nations and systems where this issue is being addressed with positive impact to business, society and individuals. For the past several years, Mercer has published the Melbourne Mercer Global Pension Index to provide a framework for comparing and rating retirement savings and income systems around the world.

The index has become influential with policymakers and industry

professionals owing to the aging population phenomenon in most markets around the world. It is regarded as unique in its ability to examine such indicators as benefit scheme design, total assets under management, demographics, government debt and regulation, while weighing the impact of those and other factors on the adequacy, sustainability and integrity of each pension system.

Among the 25 countries examined in the 2015 Melbourne Mercer index, China – along with the four other Asia-Pacific nations studied: Japan, Korea, India, and Indonesia – has a pension system with some desirable features, but also major weaknesses that, if addressed, could better the situation. China’s system could be improved by:

- ▶ Offering more investment options to members and thereby permitting a greater exposure to growth assets
- ▶ Improving the level of communication and transparency required from pension plans to members
- ▶ Continuing to increase the coverage of workers in the pension system
- ▶ Introducing a requirement that part of the lump-sum retirement benefit must be taken as an income stream
- ▶ Increasing the state pension age (a state proposal to do so is now being discussed)

Clearly, there will be more income drawdown legislation in the coming years. It’s going to be interesting to see if, for example, traditional annuities will prevail, or if there will be more drawdown products that

use the capital markets to hedge investment and longevity risk.

One capital-market approach is to bolster pensions with diversified income streams such as investment earnings and bonus payments. For example, longevity pools (pools of money to which plan members contribute payments) can yield bonus payments to surviving plan members based on how long they have been contributing to the pool. (These are features of Mercer’s LifetimePlus product, currently offered in Australia’s pension market.)

A critical takeaway from the Melbourne Mercer Global Pension Index and other analyses is that the pension systems in China and other nations facing similar aging-population challenges can only keep delivering if they are adjusted for the realities of longevity. Beyond some of the improvements recommended for China, that would include appropriate regulation as well as more diversified asset classes, minimum funding level requirements and increased workforce participation among older cohorts.

The challenges can seem daunting, but there is the opportunity, as well as the obligation, to meet the issues of longevity and retirement adequacy head-on. It requires what I call the “triple play” of government, companies and individuals to do all they can to encourage and ensure greater – and earlier – savings for retirement. The strategies are within reach, but there must be commitment on the part of all stakeholders in China and everywhere, so that our workforces can build their tomorrow today.

This article first appeared on BRINK on April 29, 2016.

ONE BELT, ONE ROAD: RISKS AND COUNTERMEASURES FOR CHINESE COMPANIES

Miao Lu, PhD

Executive Secretary General of the Centre for China and Globalisation



China proposed its “One Belt, One Road” initiative in 2013. This ambitious scheme seeks to connect China more closely with Europe, Southeast and Central Asia, the Middle East and Africa. The project is bound up with the promotion and exercise of China’s “soft power,” aimed at devising Asian solutions for Asian problems.

One Belt, One Road is strongly influencing the flow of Chinese outbound investment. The initiative is creating significant opportunities for Chinese state-owned enterprises, especially those involved in

transportation infrastructure, railway construction, energy and resources exploitation and shipping and logistics firms. Small- to medium-sized enterprises involved in manufacturing light goods and technologically advanced products are also boosting their investment activity in One Belt, One Road countries.

According to the Chinese National Bureau of Statistics, Chinese investment in One Belt, One Road countries amounted to \$92.46 billion in 2014, 15 times higher than it was in 2005.

Chinese investment in One Belt, One Road countries amounted to \$92.46 billion in 2014, 15x higher than it was in 2005.

Like any large-scale and ambitious undertaking, One Belt, One Road entails not just great opportunities, but considerable risks as well.

POTENTIAL RISKS

POLITICAL RISKS

One set of risks stems from the complicated political situation prevailing across large stretches of overland and maritime covered by One Belt, One Road. Myanmar is a case in point. Chinese investment in the country fell from \$407 million in the 2012 fiscal year to just \$46 million in the 2013 fiscal year, a drop of nearly 90 percent. This plunge was caused by rising anti-Chinese sentiment and opposition to key projects in Myanmar, notably the \$3.6 billion Myitsone dam in the northern part of the country.

Big power rivalry in ASEAN countries, South Asia and Central Asia may also threaten Chinese investment activities in these areas. China and Japan are competing to raise their influence in South Asian countries. At the beginning of 2016, Japan secured Dhaka's approval to begin building an 60-foot-deep port in Matarbari, on the southeast coast of Bangladesh. Meanwhile, China and Bangladesh were continuing to negotiate approval for the Sonadia deep water port, which is located about 15 miles away from Matarbari.

Potential risks also exist in the One Belt, One Road Central Asian countries. Conflicts exist between Kyrgyzstan, Tajikistan and Uzbekistan. For example, Uzbekistan strongly opposes China's hydropower project in, as the proposed dam is located upstream on the Amu Darya River in Tajikistan. This investment could therefore adversely affect

Uzbekistan's access to water, a scarce resource in Central Asia.

SECURITY RISKS

Chinese investment in countries along One Belt, One Road may be exposed to regional turmoil and conflicts, terrorism and religious conflicts. It is worth noting that Chinese enterprises investing overseas have yet to devise a comprehensive security strategy for dealing with such risks. They currently rely mainly on Chinese consular and diplomatic protection, which are certainly inadequate safeguards against major threats such as terrorism and ethnic and sectarian religious violence.

For its part, China has repeatedly stated that One Belt, One Road is for promoting economic and cultural exchange, as opposed to being a Trojan horse for extending Chinese geopolitical influence. But China still seems to have problems establishing the credibility of this message.

ECONOMIC RISK

Chinese enterprises with investments in One Belt, One Road countries face economic risks. One major risk is the potential of these countries defaulting on foreign lending and investment projects. Many of the One Belt, One Road countries, especially those in Central Asia, are among the poorest economies in the world and have dysfunctional and corrupt governments. This lack of creditworthiness makes them poor bets for investment on the part of China's government and Chinese financial institutions and businesses.

Another source of risk lies within the Chinese companies themselves doing business in One Belt, One Road countries. A great deal remains to be done with respect to

engineering safety and management issues. At times, firms also have difficulties obtaining sufficient intelligence and financing to effectively carry out investment projects. When these fail to properly gather information and conduct due diligence, they are more prone to engage in speculative, bubble-like investment behaviour. Chinese companies planning to "go global" by undertaking One Belt, One Road projects need to up their game when it comes to corporate governance and investment decision-making.

COUNTERMEASURES

OUTSOURCING EXPERTS TO CONDUCT RISK ANALYSIS

Chinese enterprises need to be business-like and realistic in factoring potential risks into the cost of investment projects. They need to make the best use of top-flight foreign risk analysis firms, while also employing the expertise of leading Chinese think tanks doing risk analysis, such as the Chinese Academy of Social Sciences.

LET THINK TANKS PLAY A BIG ROLE IN RISK MANAGEMENT OF ONE BELT, ONE ROAD INITIATIVES

Think tanks, particularly those run independently, are in a better position to evaluate development risk. Firms investing in One Belt, One Road should involve such organisations in planning for such projects and attempting to balance the interests of the stakeholders involved in them. Setting a network of cooperative the One Belt, One Road zone think tanks should promote in-depth and comprehensive discussion of the problems and concerns of the relevant parties.

SET UP A SECURITY MECHANISM TO ADDRESS SECURITY CONCERNS

In the short term, Chinese companies ought to beef up their internal security by making use of good private security contractors. In the long term, however, they need to establish trust and build durable partnerships with local stakeholders in the One Belt, One Road countries targeted for investment.

ATTACH MORE IMPORTANCE TO CORPORATE SOCIAL RESPONSIBILITY

Chinese companies investing abroad should be more concerned about corporate social responsibility, which can be a key element in enhancing China's "soft power" in the One Belt, One Road area. Firms should pay especially close attention to their treatment of local workers and the environmental impact of investment projects (both issues in Myanmar). Effective corporate social responsibility can go a long way in reducing the internal security risks faced by firms seeking to invest in One Belt, One Road countries.

CAPACITY BUILDING IN NURTURING PARTNERSHIP WITH NGOS AND THE CIVIL SOCIETY

Chinese enterprises with outbound investments need to pay more attention to local nongovernmental organisations and work with civil society actors in One Belt, One Road countries. One road countries where NGOs are very active are becoming important spokesmen for civil society. While doing projects, NGOs should be invited to express their concerns and interests.

RECRUITING AND NURTURING TALENT WITH AN INTERNATIONAL MINDSET

To better understand conditions in diverse and complex foreign environments, Chinese companies investing in One Belt, One Road must effectively integrate knowledgeable foreign talent into the management of overseas investment operations.

Equally important, two-way educational and cultural exchange between Chinese and local people in One Belt, One Road areas should be promoted. This can play a crucial role in promoting cross-cultural awareness between China and One Belt, One Road countries. To this end, a One Belt, One Road scholarship fund ought to be established to enable students from these countries to study in China, and likewise, Chinese to live and learn about places like Kazakhstan, which have very different and unique cultures and social norms.

This article appeared on BRINK on April 28, 2016.

HOW SHOULD BUSINESS REACT TO CHINA'S WATER CRISIS

Cate Lamb

Head of Water at CDP



Home to a fifth of the world's population, but only 7 percent of global freshwater supply, China is already at a disadvantage when it comes to ensuring it has enough water to secure its future growth and prosperity.

Yet the price of water in China is much lower than the rest of the world – less than 50 cents per cubic metre compared to over \$2 globally. And demand is only set to grow: by 2030 it is expected to outstrip supply, resulting in economic losses of \$35 billion a year.

This is not only a worry for China, but for the rest of the world. Given our global reliance on Chinese industry, the impacts of China's water challenge have the ability to echo through supply chains across the world.

With almost \$1.5 trillion in water investments set aside over the next

decade however, it is clear that the Chinese government is committed to tackling this urgent economic and environmental issue. All water users in the country, businesses in particular, will have to help deliver on these goals. But have companies truly understood the risks, and just as importantly, opportunities, that this new regulatory era will bring?

THE REGULATORY SHIFT

This year, World Economic Forum experts ranked the water crisis as the top long-term threat facing humanity. However, dealing with such a complex long-term threat requires swift action now.

Regulators in China have understood the need for such urgency. China's 13th Five-Year Plan places significant emphasis on tackling water issues, second only to achieving the country's energy

targets. The Plan acknowledges the relatively poor quality of China's water resources and the severe over-extraction of groundwater in some regions, setting the stage for more stringent regulation, enforced with strengthened environmental law.

China's Hebei province, which surrounds the capital, Beijing, is an important case study for change. Located in the dry north of the country, Hebei is home to much of China's heavy industry, steel in particular, but is also an important agricultural region. The competition for water among these water-intensive industries is strong – the region's steel output is expected to be capped at 200 million tons per year, which would still require a dizzying 12 trillion gallons of water to produce.

Now Hebei has become the test bed for the country's first ever tax on water, with a pilot introduced this July. The extraction of surface and groundwater will now be taxable, with the aim of encouraging industry to focus on resource conservation and ways to drive forward sustainable growth.

The consequences for not falling in line are also getting tougher.

China's revised environmental protection laws have an increased focus on strict compliance and imposing punishments on environmental violators.

This is not to be taken lightly. In January this year China's top court upheld the original ruling of an environmental public interest case, ordering six companies

to pay more than \$26 million in compensation for discharging waste acids into two rivers in 2012, the largest environmental penalty imposed to date.

This year, World Economic Forum experts ranked the water crisis as the top long-term threat facing humanity.

WHERE BUSINESS COMES IN

Is the message getting through to industry? Perhaps. Speaking with a state news agency, Xinhua, one glass-factory manager in Hebei described how environmental inspections used to be like a slap in the face, but now were more “like having a knife to the neck.”

The real test of course is not how sharp business believes the regulatory impacts will be, but what the regulations are doing to improve water management practices and innovate in the face of such challenges.

Each year, companies are asked by their supply chain customers and investors to detail their approach to managing both water risks and opportunities through CDP, the global environmental disclosure platform.

Based on responses from over 120 companies in China to CDP in 2015, it is clear that Chinese firms appear at risk of being caught out by the changing regulatory

landscape. This is especially the case when compared to multinational firms with operations in China.

Just over a third of Chinese firms report conducting basic measurements of their water usage compared to 82 percent of multinationals. As the adage goes, you can’t manage what you don’t measure, and adapting to regulation means companies will need to look at the basics of their water use. It is a similar story when it comes to undertaking water risk assessments, with just 41 percent of Chinese firms undertaking one compared to nearly nine in 10 of their multinational peers.

The increasing cost of water means companies will have to rapidly rethink how they factor water into their business strategy. Companies are already seeing an impact: Volkswagen, Sekisui Chemical Co., Ltd. and Mars all report higher water prices, resulting in potential impacts such as higher operating costs or a reduction in revenue. Mars’ operations in China have experienced increasing water costs since 2009, in line with the government objective to limit water usage.

WHERE THERE IS RISK, THERE IS REWARD

While changing regulatory landscapes may place restrictions on businesses unprepared or unable to adapt, it is not always viewed this way by the private sector.

Companies are starting to view effective regulation and sound water governance as fundamental to enabling vibrant business growth; 74 percent of the companies in our analysis report that water action offers operational, strategic, or market opportunities.

The Brazilian mining firm, Vale, for example, has implemented a number of water efficiency projects throughout its global operations, including China, with estimated financial savings of \$76 million. Examples include the installation of leak monitoring equipment and automated water metres leading to a reduction in total water demand.

Companies, such as Vale, that are actively pursuing improved water use monitoring and efficiency may be well-placed to operate in a water-constrained environment under regional and sectoral water caps.

This story ultimately boils down to the winners and the losers. China’s new approach to water indicates that the era of cheap, unregulated water is coming to an end. It is now up to business to decide how to succeed by pursuing a path of innovation and growth that respects these environmental boundaries. The business case for building a water-secure future has never been stronger.

This article first appeared in Agenda blog of the World Economic Forum and BRINK on September 11, 2016.

CHINA'S AGING POPULATION: MORE THAN FIFTY SHADES OF GREY

Jacques Penhirin

Partner at Oliver Wyman, China

James Yang

Engagement Manager at Oliver Wyman



The rise of the elderly population in China has been anticipated for many years, but the question of how best to serve this market's complex needs is still being deliberated. One thing is certain: Companies that do not plan well for the surge in demand from the old will miss out on a growing opportunity.

China's elderly population will almost double to 455 million by 2030, and the consumption of products and services by the elderly is predicted to reach \$150 billion by 2050. Its aging population is both a challenge and an opportunity for businesses.

Companies that are able to respond to three areas of potential growth – the desire of the elderly population to protect their health and financial well-being; their wish to reduce the

burdens on their family; and their eagerness to enjoy new experiences – will stand to benefit.

FROM GOLD TO GREY

China's rapid economic growth has been driven by a large and productive labour force. The baby boomers of the fifties and sixties began to prosper in 1979, under Deng Xiaoping's "reform and opening" policy. These demographic groups spent their most productive years working in factories and building businesses. The Chinese economy experienced an unprecedented 30-year period of GDP growth, which many simply describe as the "China Miracle."

The concurrent explosion of wealth in China has led to rapid

improvement in quality of life. Infant mortality has been on the decline since 1950, and life expectancy has risen to 76 years, its highest level. However, this formerly young and vibrant economy is now aging quickly. China is struggling to keep pace with these changes, which are characterised by:

- ▶ A declining working population, as baby boomers hit retirement age and the historic effects of the "one-child policy" kick in
- ▶ A public social security system under strain as it pays retirement benefits for the elderly
- ▶ A rising population of the "empty-nested elderly" – those living alone without the support of their child, who is likely to have moved to a city to seek better employment opportunities

NO MORE REPLACEMENTS – FOR NOW?

China is now at a critical junction. The baby boomers are at retirement age and exiting the workforce, while the one-child policy has stifled the country's ability to replace the labour required to staff "the factory of the world."

There are currently approximately 3.4 working adults in China for every elderly person aged 60 and above. By 2030, this dependency ratio will decrease to 1.5, meaning

that the burden of the elderly on the working population will be more than double. The “golden child” family model, where one child received the undivided attention of six adults (parents and two sets of grandparents), is about to undergo a dramatic U-turn.

The government is cognizant of this and has attempted to rectify the situation by ending the one-child policy in October 2015. However, many experts believe its impact on demographics will not be very significant in the short term, given the high costs of raising child in China today.

SOCIAL SECURITY SYSTEM UNDER STRAIN

Although efforts have been made in recent years to reform the social security system, it remains heavily underfunded. Total public pension funds accounted for only 5.9 percent of GDP in 2015 – far lower than in many other economies.

China’s retirement age is expected to be postponed for the first time since the 1950s. In March 2015, the Ministry of Human Resources and Social Security announced that the retirement age for both urban males and females will be gradually pushed back to 65, starting as early as 2017.

Although no formal announcements have been made, it is widely believed that health insurance coverage is also due for a decrease, covering a lower percentage of payments and thereby relieving the strain on China’s social security system.

While these demographic shifts present significant policy challenges, opportunities exist for businesses to exploit the gaps in the provision of services by the public social security system.

GREY IS GOOD

Many believe that the rapid pace of societal aging could spell doom for China. However, it could present companies with opportunities, provided they plan accordingly. According to the China Research Centre on Aging, the consumption of products and services for the elderly is already worth more than \$6 billion in China. A few areas of opportunity are as follows:

KEEP ME HEALTHY

As more emphasis is placed on quality of life for the elderly, there is increasing demand for products and services that promise greater well-being. Proper long-term elderly care is in severe short supply in China. For example, it is estimated that there are just over seven million beds available for elderly care in China, enough for only 3 percent of the total aging population (and far below western standards of 5-7 percent).

DON’T WORRY ABOUT ME

China’s elderly are very keen to generate financial security for themselves and future generations. This ambition is yet to be fulfilled. The lack of financial options for these individuals and upcoming retirees has resulted in a portfolio largely consisting of real estate and cash, which does not cater to their needs. Insurance products for long-term savings and care will become highly sought after as the elderly seek low-risk investments that complement their pension plans and offer reassurance that medical and additional care costs will be affordable as they grow older.

I WANT TO EXPERIENCE NEW THINGS

If their personal health and financial well-being are taken care of, the elderly are certainly not

averse to entertainment and new experiences. One of the most popular smartphones sold online in China, for example, is specifically targeted at the elderly. Similarly, travel tours designed exclusively for seniors – with activities focused on them – are also increasingly common.

I WANT TO STAY AT HOME

In the grey market, homecare services will be among the most promising areas of opportunity for business. Homecare is expected to remain the dominant eldercare model in China, and this opens an array of opportunities ranging from the provision of light services such as housekeeping and meal delivery on the one hand to high-tech services such as remote medical treatment on the other.

MORE THAN FIFTY SHADES OF GREY

The elderly rich in urban China have gone to considerable lengths to ensure that the latter stages of their lives will be comfortable, but what works for them is vastly different to what the elderly in rural China want to prioritise. Therefore, a scattergun approach is outdated, and business strategies need to be sophisticated, specific and targeted.

Retirees over the next 10 years will also think and act very differently from their predecessors. The rapid economic growth in China has produced a broad range of people with very diverse experiences and mind-sets, and this needs to be taken into account in formulating any strategy.

What remains to be seen is whether businesses pay heed and acknowledge that the answers aren’t in black or white, but in several shades of grey.

This article appeared on BRINK on September 7, 2016.

BEHIND CHINA'S ATTEMPT TO SPREAD THE RISKS FROM ITS DEBT-FINANCED GROWTH

Prasenjit K. Basu

Founder at REAL-Economics.com



Capital outflows from China are an inevitable feature of the excesses that have afflicted its economy over the past two decades, and while nations do potentially benefit economically from the infusion of China's capital inflows, recipient countries are legitimately wary of the threats to their sovereignty and security from Chinese ownership of key assets.

In the eight years since August 2008 (i.e. just before the start of the global financial crisis), China has had the largest monetary expansion in human history. Its M2 money supply has grown from \$6.5 trillion in August 2008 to over \$22.3 trillion now. The stock of US M2 is \$12.8 trillion, and has increased by a relatively mild \$5.05 trillion in the past eight years, compared with China's \$15.8 trillion increase.

Given that China's economy is about half the size, its economic imbalances have been greatly exacerbated by this extraordinary surge in money and credit.

SWELLING OVERCAPACITY

While all that money and credit has helped to rapidly build out China's infrastructure in support of its expanding industrial base, capacity-expansion far outpaced any external or domestic demand for that capacity. China now faces an unprecedented mountain of overcapacity in most capital-intensive industries (steel, petrochemicals, other metals, semiconductors) and in property. In the past three years, China has sought to pump ever more credit into the economy, in order

to somehow hold the fragile edifice together and prevent industrial prices from collapsing.

China's trade surplus has burgeoned over the past two years, aggregating \$1.15 trillion over that period. But its foreign reserves have declined by \$800 billion, implying that services/income and capital outflows have soared to \$1.95 trillion over the last two years. China's citizens are taking large proportions of the new money being printed in China and investing it in overseas assets.

The bulk of these overseas investments have gone toward the purchase of real-estate, with favoured destinations being London, New York, San Francisco, Sydney, Melbourne and their suburbs. Singapore and Hong Kong's property markets were early recipients. Anecdotal stories abound of busloads of Chinese buyers descending on a property and offering to pay the full price in cash – overwhelming local buyers, who meticulously evaluate a property keeping in mind their banks' willingness to grant a mortgage loan.

For property owners across the world, the arrival of the cash-rich Chinese buyer is a boon. But, by buoying property prices, they also contribute to income inequality, placing more properties outside the reach of most locals. The phenomenon of Londoners moving to the suburbs as the centre of their city becomes unaffordable is a pattern occurring in more cities around the world, with the likes

of Kuala Lumpur, Bangkok and even Iskandar feeling the impact of mainland Chinese buyers.

ONE BELT, ONE ROAD, MANY OBJECTIVES

The most benign form of Chinese investment overseas is the government's "One Belt, One Road" initiative to use surplus Chinese capital to invest in infrastructure across Asia, Africa and around the world. Indonesia's high-speed rail project, which connects Jakarta to the hill town of Bandung, 140 kilometres away, was controversially won by China (despite Japan having done the feasibility study for a project extending all the way south to Surabaya) after China offered an interest-free loan.

Similarly, China has offered a massive \$40 billion in credit to Pakistan to build highways and other infrastructure across the Himalayas in disputed territory occupied by China and Pakistan – aimed at connecting Xinjiang (formerly East Turkestan) to the port of Gwadar in Baluchistan. Separately, a Chinese-led consortium won the right to build the Hinkley nuclear power plant in the UK, but the new government of Theresa May immediately ordered a rethink of the project on security grounds. While the Cameron government

had gone out of its way to court China – snubbing its US alliance in order to become a founding member of the China-controlled Asian Infrastructure Investment Bank (AIIB) – Cameron's successor decided that the security issues needed to be thoroughly understood.

THE SEARCH FOR GROWTH

This year has also seen a rash of hostile takeover attempts by Chinese groups of choice businesses in the US and Europe. In the first half of 2016, there were at least 13 such bids totalling \$78 billion in value.

China's Midea group, a consumer-appliance manufacturer, made a \$5 billion bid for Kuka AG, a German robotics company, which prompted Germany's economy minister to contemplate an alternative German offer for Kuka, given the company's crucial role in the country's automotive sector.

And Anbang Insurance made a celebrated offer to acquire Starwood (the hotel company that owns the Sheraton, Westin, Le Meridien and other brands) for \$14 billion, topping the offer from rival group Marriott. This triggered interest, partly because Anbang's chief executive was married to the granddaughter of Deng Xiaoping, the father of China's modern economic success. The offer eventually fell through because

China's insurance regulator opposed the deal, although other security concerns were just below the surface.

THE GLOBALISATION OF RISK

The Chinese Communist Party still has the final say in all state-owned enterprises, and it influences decisions at most nominally-private Chinese companies. Consequently, the recipients of unsolicited bids by Chinese companies are naturally suspicious about Chinese intentions – and governments, too, will continue to examine such bids; both from the standpoint of competition policy and internal security.

With China's financial system poised on the precipice of a crisis of bad debt arising from its glut of real estate and industrial capacity, the greatest danger is that China could globalise its internal imbalances by connecting its financial system more symbiotically with the rest of the world. That is a danger that the major central banks and regulatory authorities have done well to avert thus far.

The source for all national-level data is CEIC, with aggregations done by the author from CEIC's monthly data (which is derived from the national statistics agencies).

This article appeared on BRINK on September 6, 2016.

CHINA CONTINUES TO BATTLE MASSIVE CAPITAL FLIGHT PROBLEM

Alicia García-Herrero

Senior Fellow for BRUEGEL and Chief Economist for Asia Pacific at Natixis



Last summer, China's stock market collapse and unexpected devaluation deepened its capital outflow problem and accelerated the fall of reserves, which had started in mid-2014. Since February, reserves have started to stabilise. While the situation is clearly better, China continues to struggle in terms of stabilising its massive capital outflows.

Within that context, foreign reserves seem to have become a policy target. Although capital outflows are still large, it's not enough for reserves to start falling again. In 2015, the largest net outflows stemmed from the repayment of bank loans (close to \$500 billion in "other investment" outflows), followed by unrecorded outflows of residents amounting to nearly \$200 billion.

Portfolio flows (equity and bond) were also negative, but smaller. The situation has hardly improved in 2016, based on first quarter data. In fact, all types of capital recorded outflows, even net foreign direct investment (FDI), which was not the case in 2015.

RESIDENTS DRIVING THE OUTFLOWS

It's important to note that Chinese residents have been driving capital outflows for years. The difference in 2015 is that non-residents stopped investing in China and started to move their capital out. Still, the bulk of the outflow was made by residents. These are unrecorded outflows and also include the investment

of Chinese companies, as well as the loans of Chinese banks abroad (increasingly in the emerging world).

Looking into the details, currency and deposits were the bulk of the outflows (other investment) in 2015, while repayment of bank loans – as well as Chinese banks' loans to overseas companies – have become more important during the first quarter of 2016. Portfolio investment has turned negative for both residents and nonresidents. Finally, for the first time since China's open door policy, the first quarter of 2016, the direct investment of Chinese companies abroad surpassed foreigners' direct investment in China.

A PEEK BEHIND THE CURTAIN: THE MAGIC OF FOREIGN RESERVES STABILITY

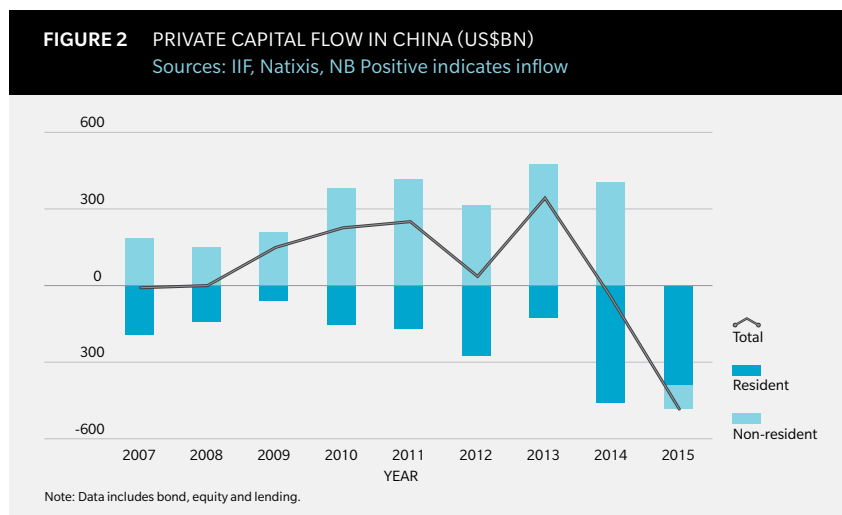
Achieving stability of reserves requires a high degree of precision and tools. Beyond lifting the constraints on portfolio inflows – which does not seem to have worked yet, as net portfolio outflows have been larger than ever in the first quarter of 2016 – outflows need to be managed more tightly.

Beyond official controls on outflows, there are at least four ways in which capital outflows from China may have been cushioned to avoid a loss of foreign reserves beyond

official balance of payment data. First, capital leaving China could be in yuan instead of foreign currencies, which would not affect the level of foreign reserves. In fact, since October 2015, there has been a net outflow of yuan from China. Given that the CNY-CNH interest rate spread is positive, arbitrage reasons cannot explain such outflows. Further, these outflows are actually pretty sizable (-\$207 billion since October last year).

Second, it has often been argued that China's capital outflows were mostly good rather than "bad cholesterol" (i.e. it was Chinese companies and banks repaying debt). While their exposure to foreign borrowing has been reduced from the peak in 2015, the scale is not as massive as generally perceived. China's total debt in foreign currency amounted to \$1.705 trillion in the second quarter of 2016, a mere 15 percent decrease since its peak in the same quarter last year. Offshore issuance of foreign currency bonds by Chinese companies has been quite steady, while loans from banks offshore have been reduced. With regard to the offshore bond market, Chinese companies have continued to issue quite massively, but the net issuance has come down thanks to a wave of early redeemed bonds, most of which were issued by Chinese real estate developers.

Third, it is generally argued that the spending abroad by Chinese companies is behind a good chunk of the capital outflows, but it's not. FDI net flows were positive until the



first quarter of this year and, even now, the net outflow – as recorded in the balance of payments – is moderate. This might sound strange given the large M&A operations by Chinese companies announced since the beginning of 2016, but it is not contradictory, as a good part of those deals may have been financed outside China (leveraged buyouts financed in the offshore market).

Finally, some of the businesses closer to the state, China Investment Corporation being the best example, seems to have reduced the share of foreign assets as opposed to domestic assets, thereby reducing capital outflows from its purchases. More generally, M&A engagement is one thing, but bringing foreign reserves out of China is another.

Anyway you do the math, capital outflows from China continue to be massive. A large current account

surplus continues to cushion a potential fall in reserves, but more seems to be happening for reserves to be stable. Looking deeper into the nature of outflows, one has to conclude that the situation remains fragile. It is still residents driving the outflows and they do not seem to be a "good cholesterol" type (i.e. repayment of debt or purchases of assets abroad).

Meanwhile, China hasn't fully resolved its balance-of-payments problem. The reserves are massive, but so are the "bad cholesterol" outflows. It is time to go to the doctor and increase the return on assets for capital to be willing to come back. Unfortunately, the Chinese authorities seem to be heading in the opposite direction, with increasingly lower interest rates and a lack of real reform for state-owned enterprises.

This article appeared on BRINK on September 23, 2016.



About Oliver Wyman

Oliver Wyman is a global leader in management consulting. With offices in 50+ cities across 26 countries, Oliver Wyman combines deep industry knowledge with specialised expertise in strategy, operations, risk management, and organisation transformation. The firm's 3,700 professionals help clients optimise their business, improve their operations and risk profile, and accelerate their organisational performance to seize the most attractive opportunities. Oliver Wyman is a wholly owned subsidiary of **Marsh & McLennan Companies** [NYSE: MMC], a global team of professional services companies offering clients advice and solutions in the areas of risk, strategy and human capital. With annual revenue of \$13 billion and 57,000 colleagues worldwide, Marsh & McLennan Companies provides analysis, advice, and transactional capabilities to clients in more than 130 countries through: **Marsh**, a leader in insurance broking and risk management; **Guy Carpenter**, a leader in reinsurance and intermediary advisory services; and **Mercer**, a leader in talent, health, retirement, and investment consulting. For more information, visit www.oliverwyman.com. Follow Oliver Wyman on Twitter [@OliverWyman](https://twitter.com/OliverWyman) or on [LinkedIn](#).

About Asia Pacific Risk Center

Marsh & McLennan Companies' **Asia Pacific Risk Center** draws on the expertise of Marsh, Mercer, Guy Carpenter, and Oliver Wyman, along with top-tier research partners, to address the major threats facing industries, governments, and societies in the Asia Pacific region. We highlight critical risk issues, bring together leaders from different sectors to stimulate new thinking, and deliver actionable insights that help businesses and governments respond more nimbly to the challenges and opportunities of our time. Our regionally focused digital news hub, BRINK Asia, provides top executives and policy leaders up-to-the-minute insights, analysis, and informed perspectives on developing risk issues relevant to the Asian market.

Copyright © 2016 Oliver Wyman

All rights reserved. This report may not be reproduced or redistributed, in whole or in part, without the written permission of Oliver Wyman and Oliver Wyman accepts no liability whatsoever for the actions of third parties in this respect.

The information and opinions in this report were prepared by Oliver Wyman. This report is not investment advice and should not be relied on for such advice or as a substitute for consultation with professional accountants, tax, legal or financial advisors. Oliver Wyman has made every effort to use reliable, up-to-date and comprehensive information and analysis, but all information is provided without warranty of any kind, express or implied. Oliver Wyman disclaims any responsibility to update the information or conclusions in this report. Oliver Wyman accepts no liability for any loss arising from any action taken or refrained from as a result of information contained in this report or any reports or sources of information referred to herein, or for any consequential, special or similar damages even if advised of the possibility of such damages. The report is not an offer to buy or sell securities or a solicitation of an offer to buy or sell securities. This report may not be sold without the written consent of Oliver Wyman.