Oversears markets prepare for an inflow as China turns on the tap

The need to slow growth of foreign exchange reserves is prompting Beijing to allow portfolio holdings abroad

Last August, some of the world's most powerful money managers crammed into the meeting rooms of a discreet business hotel on the outskirts of Beijing. Sharp in their suits and polished shoes, the managers were hoping to impress a group of senior Chinese government officials during a one-day "beauty parade".

Three months later, 10 financial groups received the big prize - the right to manage the first overseas investments of the $50bn (£26bn, €39bn) state pension fund. These initial investment mandates are the first trickle in what is expected to be a flood of overseas investments by cash-rich Chinese banks, insurers and pension funds.

"The opportunity to play an active role in investing Chinese capital offshore represents to most - if not all - international firms the Holy Grail of investment management," says Shiv Taneja, at Cerulli Associates, a research firm.

The latest deal came last month, when Franklin Templeton, the US fund manger, formed an unprecedented joint venture with China Life, the country's biggest insurer. The arrangement will allow China Life to invest a big chunk of its fast-growing assets abroad for the first time.

Analysts say local insurers and pension funds will not be able to meet their long-term liabilities unless they invest some of their money into higher-yielding foreign securities. It is a shift that has been hailed as a potential "wall of money" to hit equity markets such as Hong Kong, the first port of call for many Chinese investors.

Yet while international money managers display glee, the biggest smiles are on the faces of the Beijing bureaucrats and central bankers who have unleashed and encouraged this trend.

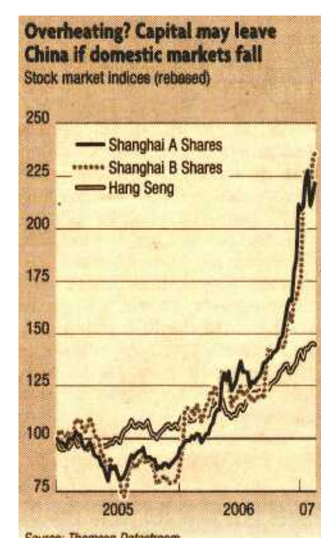
Chinese banks, insurers and fund managers last year received approval to invest overseas for the first time through a quota system, known as the Qualified Domestic Institutional Investor scheme. More than $100bn worth of investments could be channelled through the QDn programme during the next two years, according to Z-Ben Advisors, a research firm in Shanghai.

The prospect reflects a remarkable policy change in a country that prides itself on having one of the world's toughest controls on inward and outward movements of money.

Since the Asian financial crisis of 1997-98, leaders of emerging economies such as China have accepted as an article of faith that unbridled capital flows can lead to speculative attacks, capital flight and currency devaluations akin to those that afflicted Thailand and Indonesia. Many economists recommend that countries should maintain stringent capital controls so long as they lack a sound and stable banking system, flexible interest rates and a flexible exchange rate - a set of tools that China has yet to develop fully.

So why is China starting to open the tap? Beijing hopes to use controlled outflows to slow the growth of its foreign exchange reserves, the world's largest at more than $1,000bn. "This will be one of the biggest policy moves of 2007," says Jonathan Anderson, UBS chief economist for Asia. "We will see a growing number of official announcements and policies that may lead to significant capital outflows."

In recent years, hundreds of billions of dollars have flooded into China's financial system, mostly through trade surpluses and inward investment in sectors such as manufacturing and property. Left unchecked, these inflows would put upward pressure on the renminbi - undermining the competitiveness of exports, the main driver of the country's breakneck economic growth. Given Beijing's policy of allowing only an incremental appreciation of the renminbi, the People's Bank of China, the central bank, has to absorb the bulk of these foreign currency inflows by accumulating reserves.



Holding massive reserves is not a problem in itself. Yet Chinese central bankers are fretting about the potentially rising cost of the accumulation process: in order to mop up, or "sterilise", the excess liquidity generated by its foreign exchange purchases, the PBoC has been issuing specially designed local currency bills.

The outstanding stock of these short-term securities - worth about $400bn and growing - has to be rolled over every three to six months, a process that would force the PBoC to pay higher rates to bondholders if domestic interest rates were to rise. Hence Beijing's drive to encourage local institutions and individuals to shoulder some of the burden.

On current projections, Chinese official reserves could double to more than $2,000bn within four years. "Someone in China - whether the PBoC, state banks, state pension companies or state firms - may need to add as much as $400bn to their holdings of foreign assets this year," says Brad Setser, head of research at Roubini Global Economics in New York.

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Capital has already started to seep out. In the second half of last year, China saw an estimated outflow of about $49bn worth of speculative money, according to Standard Chartered. This year, outflows could be larger still.

Following a recent policy switch, Beijing is to diversify the country's foreign reserves, 70 per cent of which are believed to be held in dollar-denominated assets such as Treasury bonds and mortgage-backed securities. To generate higher returns, the PBoC is quietly handing out investment mandates to international fund managers specialising in equities.

The latest policy change also suggests that China may use a chunk of its reserves to create a powerful state agency akin to Temasek, Singapore's government investment arm. The PBoC is meanwhile expected to step up its ultra-discreet foreign exchange swaps with local banks - transactions that provide banks with dollars to lend or invest, without forcing them to take on foreign exchange risk. Beijing will also continue to promote its "go out" industrial policy by encouraging direct investment abroad, especially in strategic sectors such as oil and gas.

Above all, Beijing is expected to lift some of the restrictions on its QDII programme. So far, some 16 banks and one fund management house have been allowed to invest up to $13.4bn abroad on behalf of their clients, but only a tiny fraction of this total QDn quota has been used.

Local bankers blame the fact that they are required to offer only comparatively low-yielding foreign fixed-income products. Their retail clients have had little appetite for these, because of a widely expected further appreciation of the renminbi and the pulling power of the domestic stock markets, which were up 130 per cent last year.

A further relaxing of the QDII rules is likely to depend on Beijing's assessment of the first experimental equity-type products, including one that is co-managed by Lehman Brothers of the US.

While Chinese insurers and pension funds are ready to unleash overseas investments, retail appetite for foreign assets will depend largely on the domestic equity markets, in which there has recently been a slight correction. As Stephen Jen, Morgan Stanley's global head of currency research, puts it: "Once the bubble bursts, you might see a healthy outflow."

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Fonte: Financial Times, USA, 13 Fev. 2007. Comment & Analysis, p. 11.