

Low expectations

G. Bin Zhao says markets and the media are wrong when they predict a continued fall for the renminbi

January 2016 may have been one of the most turbulent periods for the Chinese economy since the country's reform and opening up. Within a month, the stock market fell more than 20 per cent, wiping out 10 trillion yuan worth of A-share value. Annual GDP growth fell to a 25-year low and, although within expectations, the negative impact is serious.

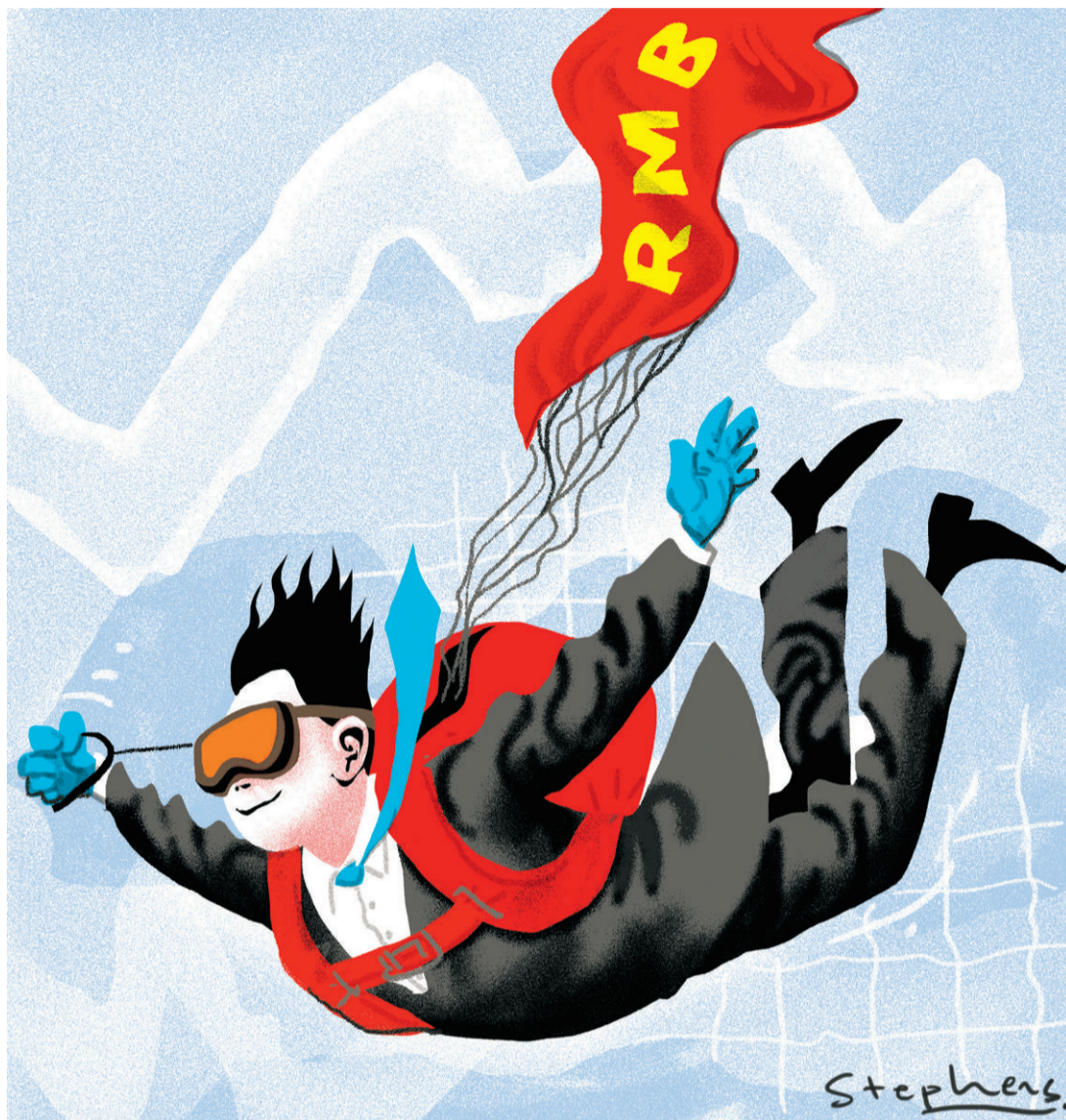
There are tough choices to be made over the renminbi exchange rate, which is in the early stages of market-oriented reform. According to international market expectations, the renminbi is expected to continue to depreciate. However, the Chinese government, including the central bank, does not agree.

Some people worry that exchange rate volatility is likely to become the next factor after the stock market to trigger significant risks. So, will this be the case?

The fact that the international market almost overwhelmingly thinks the renminbi will continue to fall in 2016 is inadequate proof that it will actually happen. An overview of world economic history shows that there is little likelihood of people actually predicting the reality, and sometimes the results may be just the opposite.

Take crude oil prices, for example. No one would have predicted the current price two years ago. When the price fell below US\$30, some expected it to fall further, to US\$20, or even more outrageously, to US\$10. When most oil production companies worldwide are facing losses, and the crude prices seriously deviate from the cost of production, can the price reflect the proper value?

Market expectations for the price of a product will, of course, affect its future price, but expectations cannot usually reverse a trend. For example, many people want the price of crude oil to return to a reasonable rate, but if the government does not interfere, market expectations will not change the reality. The fact that oil prices immediately rebounded after Saudi Arabia and



Russia took action is one example of this.

The main reasons why international markets expect further renminbi depreciation are: the US economic recovery; the Federal Reserve raising interest rates; and, the appreciation of the US dollar. Secondary reasons can be tied to China's economic slowdown, the stock market crash, and so on.

In fact, the US dollar has appreciated considerably against the currencies of most developing countries, and also against the major currencies of developed nations over the past year. However, it's hard to know whether this trend is sustainable in 2016, given the concerns about the momentum of the US economic recovery.

If China's economic slowdown is regarded as the basis for renminbi devaluation, and even if GDP growth rates in 2016 fall from the current 6.9 per cent to 6.5 per cent or even 6 per cent, the pace of development is still among those of the

leading countries globally, so why can it not support the currency exchange rate?

The impact of the Chinese stock market decline on the exchange rate is relatively limited, mainly because it represents a relatively small percentage of the real economy and therefore has limited impact on it. In the dotcom crash era from 2000 to 2002 in the US, the dollar depreciated about 30 per cent against major currencies, mainly because US\$5 trillion of stock market value evaporated, a huge hit at the time.

In addition, the renminbi exchange rate marketisation process has just started, and international expectations of the currency's value are fully reflected in the value established in the offshore Hong Kong market. Many people mistakenly think that because the exchange rate is not subject to much government intervention, it should be based on the market price.

This is a serious mistake. The renminbi exchange rate is not yet

fully market-oriented, and the offshore Hong Kong market is much smaller than the onshore market. How can the pricing mechanism of a small market determine that of a large one?

Some wishfully think that the offshore Hong Kong exchange rate represents the market price

Moreover, the offshore Hong Kong exchange rate represents only a part of the overall exchange rate pricing mechanism, and so cannot be the benchmark for the renminbi exchange rate.

Not only has the international

market mistakenly priced the renminbi exchange rate, but many domestic agencies, media outlets and individuals have also accepted this one-sided view, thus adding to the voices proclaiming that almost the entire market believes the currency will continue to fall in 2016.

No reform is fulfilled in one step, and that applies to renminbi exchange rate reform as well.

The Chinese government has repeatedly said it will insist on the principles of being autonomous, progressive and controllable when implementing reforms of the exchange rate mechanism. When Premier Li Keqiang (李克强) talked to Christine Lagarde, head of the International Monetary Fund, recently, he re-emphasised these points.

But some market participants wishfully think that the offshore Hong Kong exchange rate represents the market price.

While domestic and international markets, as well as the media, basically agree that the renminbi will continue to devalue this year, government voices have been fragile and weak.

Frequent incidents of dishonesty under the previous administration have eroded officials' credibility and it is quite common to be distrustful of the government.

Since the renminbi exchange rate mechanism is moving to be more market-oriented, different parties are fighting for the authority to speak for and influence the rate. The international market has clearly gained the upper hand at present.

If the situation is left unchecked, the central bank will be very passive, and the onshore market will be directed by the offshore Hong Kong market. This explains the recent frequent interventions in Hong Kong by the central bank.

I firmly believe that the renminbi will continue its internationalisation; in order for the currency to become accepted in global circulation and reserves in the future, the exchange rate must be fully market-driven.

However, right now, the government cannot totally let go because, if the international market has the final say on exchange rate pricing, it will create major risks in the Chinese economy. This also explains why China has successfully sustained its economic development for almost four decades.

We should not forget the painful lessons of rapid economic liberalisation in some countries; the market will have to be patient.

G. Bin Zhao is co-founder of Gateway International Group, a global China consulting firm, and executive editor at China's Economy & Policy

Risks as well as rewards in Silk Road ventures

Cary Huang says "One Belt, One Road" may be a largely sensible strategy for China, but making investments in unstable regions clearly has its dangers as well

President Xi Jinping's (习近平) "One Belt, One Road" programme could be thought of as "killing three birds with one stone".

Economically, the initiative aims to help Chinese companies explore overseas markets along the ancient trade route that linked the Middle Kingdom with the larger part of Eurasia, formally established during the Han dynasty.

The programme is also an effort to tackle overcapacity in many industries at home, nurture domestic structural reform and boost growth.

Politically, China needs true friends and political allies to offset its ideological isolation in a post-cold-war world, following the demise of socialism in the early 1990s. Beijing wants to resume its leadership status in the developing world through reviving the once widely known non-aligned movement.

Diplomatically, China's aggressive economic expansion is part of a strategy to expand its sphere of influence to forge a status equal to that of the United States and to resume China's position as the global centre of trade, culture and politics, as it was some 2,000 years ago.

Armed with more than US\$3 trillion in foreign reserves, Beijing has dramatically scaled up its loan book to foreign nations, mostly developing economies that are largely ignored by international investors and Western lenders.

Xi's recent whirlwind trip to Iran, Saudi Arabia and Egypt was one such mission: his aim, to rebuild the "Silk Road" routes while also seeking to promote China's image and influence as a global power.

But such a massive spending spree in politically unstable regions has raised questions about the potential risks for this investment.

Right now, Beijing's relationship with most Silk Road countries, from Central Asia to the Middle East, is largely defined by its energy imports, as China gets more than half its crude oil from the region. However, oil can be bought with cash anywhere in peacetime.

Few investors will choose to gamble in politically unstable environments where rule of law is weak

Chinese companies are eager to explore overseas markets elsewhere, not least along the Silk Road. But the geographical concept of the Silk Road is irrelevant when it comes to solving China's economic problems: one cannot compare today's economically integrated world to the age when camels and horses were the main mode of transport to carry goods for trade through Central Asia to West Asia and Europe.

In economics, the philosophy of investment is about the trade-off between risk and return, which is not necessarily what political leaders are good at.

In many ways, "One Belt, One Road" resembles the 4 trillion yuan (HK\$4.7 trillion) stimulus package launched in 2008; it is another political project that will be dominated by state-led investment, rather than private, as few investors will choose to gamble in politically unstable environments where governance and rule of law are weak and infrastructure is lacking. That is why patriotic Hong Kong billionaire Li Ka-shing chose to invest heavily in Britain and Canada rather than nations along the belt and road, despite the government's call to support such projects.

Politically, such investments won't help the atheist Communist-ruled nation win the hearts and minds of people from countries where religion dominates. China's regular and often harsh repression of any belief other than communism – from Christianity and Islam to Buddhism and the home-grown, quasi-religious Falun Gong – makes it difficult to forge close relations with countries where religion is an integral part of ideology, culture, politics and everyday life.

Despite maintaining good relations with most countries in the region, China is an outsider in regional affairs as it has long maintained a diplomatically neutral stance and has taken no sides in any conflict. Under this non-interventionist diplomacy, Chinese money can boost its influence, but it won't buy true friends or love.

So, the higher risk does not guarantee higher returns. Worse, if Beijing attaches too much political and diplomatic significance to such projects, there is a danger that it will see little return on its investment, or even lose money.

Cary Huang is a senior writer at the Post



Dreams of profit or influence in Silk Road countries like Iran could go up in smoke. Photo: Reuters

Indonesia can lead the way with campaign of tolerance

The year has not got off to an auspicious start for Indonesia. The country and its new president weathered multiple headwinds in 2015, and the turn of the new year brought some promise of a fresh start for the economy. But the recent attack involving bomb blasts and shootings that struck at the heart of Jakarta has brought renewed uncertainty about the already weakened Indonesian market and unnerved investors, weakening the rupiah further.

The impact of the terror attacks have economic implications for the region as well. First, they bring sharply into focus a possible future for Southeast Asia where the "war on terror" that used to take place further away, in places such as the Middle East, will make its effects felt much closer to home and with increasing frequency. Investors unused to such security risks in Southeast Asia may need to get used to them.

The challenge for governments is to reassure investors that such risks will not dim the region's prospects of becoming a growth engine for the world.

So far, President Joko Widodo's approach has been to take a measured and less dramatic approach in responding to radicalism and extremist groups in his country. Instead of calling for a war on terrorism, as the West and Middle Eastern states have done, Widodo denounced the attacks and sought to reassure his people and the rest of the world that his government and security forces have the situation under control.

Nicholas Fang and Cheryl Tan say there is a risk Indonesia could become a hotbed of terrorism, but also a chance to show how a moderate Muslim nation can lead a movement to counter extremism

While it may not have been the intended effect, the central bank's announcement that it would cut interest rates to boost growth on the back of the bomb blasts also served as an important signal to investors that, despite the tragedy and ongoing manhunt, it was business as usual in Indonesia.

Indonesia holds much promise for investors keen to take advantage of the huge consumption potential of the populous nation. But even as it continues to be one of Southeast Asia's brightest sparks, with the potential to draw foreign investors from all over the world, the country could also be the region's weakest link. Its vast archipelago and porous maritime borders represent favourable conditions and a suitable environment for terrorist cells to breed and thrive, as well as to recruit from not only within Indonesia, but also its Asean neighbours.

As a president overseeing a country with the world's largest Muslim population, Widodo's preference has been for softer and more preventive methods to balance the harder efforts of law enforcement and anti-terror forces. Since his days as mayor of Solo, he has advocated creating and working with moderate interfaith dialogue groups and encouraging public education to curb the spread

of Islamic extremist propaganda, as well as addressing socio-economic inequality to deal with radicalism and extremism.

But with terrorist activity picking up not only in Indonesia but in the region, Widodo will need to move forward with more urgency on plans to control the spread of Islamic extremism in his country. Going by his preference to tackle the root cause of extremism, this will include a multipronged approach to address development gaps and the country's widening socio-economic inequality and the lack of quality jobs, especially for the younger generation.

To do this, he needs to start by getting Indonesia's economy back on track in terms of growth. It is even more critical now for him to move ahead resolutely with several economic policy packages that his administration rolled out in the last two quarters of 2015.

They call for quality foreign investment that would not only help existing primary industries move up the value chain, but also spark the development of new industries such as e-commerce, pharmaceuticals and the information and communications technology sector. These are targeted at creating new jobs and boosting domestic consumption. Funneling investment towards

developing and modernising the many island provinces and regions outside Jakarta has also been a key priority for the Widodo administration. Ensuring the equitable development of Indonesia will be important to ensure that its people, especially the young, have less impetus to give in to the allure of radical Islamist terrorist groups in the medium to long term.

Efforts to develop the country's software – its people – should not be ignored either. Compared to its Asean neighbours, Indonesia lacks a strong professional labour force

A population that is poorly educated is also at risk of succumbing to terrorist recruitment

that is proficient in English. This is a key stumbling block in Indonesia's economic progress and its Achilles' heel if it wants to be a front-runner in the Association of Southeast Asian Nations. A population that is largely poorly educated is also at higher risk of succumbing to terrorist recruitment.

There are risks that Indonesia might become the capital of terrorism in Southeast Asia. But there is also potential for the country to show how a moderate