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A RE-AWAKENED SENSE OF DESTINY

China's ability to durably transition to the top spots in the world has posed a heightened risk that needs to be managed

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All eyes on China: *The emergence of China as a global powerhouse has long been overdue given the long and rich history of this country whose contribution to the world goes back 4,000 years. - PHOTO: AFP*

WHILE in exile following his final defeat by the British and their allies, Napoleon who knew a few things about building and losing an empire is reported to have presciently said: "Let China sleep; for when China wakes, she will shake the world." Seen from Saint-Helena island, China's imposing geographic clout and many riches might have seemed mind-blowing to the dethroned French emperor who always had a keen interest in Asia, if only to counter his British arch-enemies' ambitions in the region.

Two hundred years later, China has become a bellwether for the health of the global economy. The emergence of China as a global powerhouse has long been overdue, given the long and rich history of this country whose contribution to the world goes back 4,000 years.

The world is a different place today from what it was 30 years ago when Deng Xiaoping initiated the "open door policy" that propelled China and the world into the age of globalisation and transnational economies. Over the past decade, since it joined the World Trade Organisation (WTO) in December 2001, China has moved from the sixth largest to the second largest economy in the world, a jump nothing short of a miracle in the (relatively short) history of modern capitalism. Analysts predict that China will be the world's largest economy by 2020.

Destiny favours leaders whose actions are supported by strong fundamentals, which is undoubtedly the case of China: 1.3 billion people, a large pool of highly skilled workers, elite academic institutions, a tradition of entrepreneurship and trade. Nonetheless, such a grand endeavour as successfully steering a country the size of a continent to the very top position globally does inherently encompass some level of uncertainty, considering that the ability to manoeuvre and fine-tune macroeconomic policies in the short term is highly constrained.

Keeping this in mind, the International Monetary Fund (IMF) has been actively researching China's impact on the world economy. By applying econometric models originally designed by US Federal Reserve chairman Ben Bernanke while in academia, IMF researchers have aimed to scientifically quantify the potential spillovers of macro-economic shocks stemming from China on the world economy under various scenarios. Of particular interest are fixed asset investments and, among them, real estate markets.

Fixed asset investments have played a leading role in fostering China's growth since the country joined WTO. They amounted to 48 per cent of GDP in 2010. Under the evocative titles "Investment-Led Growth in China: Global Spillovers" (November 2012) and "The Spillover Effects of a Downturn in China's Real Estate Investment" (November 2012), IMF economists have reported that a one per cent decline in China's investment would be associated with a reduction of 0.1 per cent in global growth.

Likewise, a drop of one per cent in real estate investment in China would take about 0.1 per cent off the country's real GDP within the first year, while negative spillover impact to G-20 countries would cause a decline of roughly 0.05 per cent in global GDP. Interestingly, as fixed asset investments have increasingly contributed to China's GDP growth since the early 2000s, their estimated impact on the global economy is now five times larger than in 2002.

Risk instruments

There is no need to fall into the trap of sensationalist forecasts to understand that whatever happens in the Chinese economy will increasingly matter to all of us. In recent years, the relative risk posed by China's ability to durably transition to the very top spots it can rightfully aspire to in Asia and the world has been heightened in both intensity and scope, due to the enhanced integration of an increasingly prosperous China in the global economy. So, what instruments are available to deal with this risk? As of today, there is none.

Experts in charge of designing risk management tools are customarily wary when dealing with a new type of risk. By nature, representatives of standardised exchanges and over-the-counter product sponsors tend to be conservative inasmuch as the cost of failure of new derivatives is high. It is often reported that the concept of derivatives as hedging instruments appeared in 2000 BC in Mesopotamia where farmers and priests - trading on behalf of gods - engaged in forward contracts in order to hedge the impact of grain price fluctuations.

The concept was also very popular in antique Rome as emperors saw it as a way to insure sufficient food supplies to a large population, one of their major and, in some extreme cases, life-threatening regal duties. At each stage of the world's economic history, specific instruments were introduced either contractually (over the counter) or publicly (market listed) to deal with the most important risks of the time.

For instance, in the early 1850s, the Chicago Board of Trade listed futures contracts on bricks to accompany the construction boom in the US at that time. Incidentally the impact of China on today's commodity markets has been reported as very significant. Hence, one may legitimately wonder why there are still no instruments available to capture the new economic reality embodied by the fast emergence of China over the past 30 years and her growing importance in the global economy.

Economic derivatives

Such ad-hoc instruments could materialise as economic derivatives on China's economy, eg, options on a myriad of macroeconomic indicators including GDP, inflation rate, industrial production and even electricity consumption at the local level. By promoting such instruments, our market economy would address the need of the real economy.

In the past, attempts to launch economic derivatives on the US economy by Goldman Sachs and the Chicago Mercantile Exchange were unsuccessful, in part as a result of the auction-based pari-mutuel format adopted to trade these instruments.

The fact that the contracts failed in the US should not serve as an excuse not to explore the launch of similar, possibly improved, instruments in Asia. Investors have many other ways to hedge their macro risks in North America. There are few in Asia, let alone China, and the need for additional ways to do so is pressing. The derivatives market that will strike the winning formula will gain both business and recognition as an innovative leader. Of course, the road will be paved with multiple hurdles, starting with the need to iron out the process surrounding the disclosure of China's economic indicators.

Economic derivatives on China would enable international businesses to better deal with their China exposures in the short-medium term: from Philippines' banana producers willing to cover the risk of Chinese consumers' fluctuating yearly demand, to Singaporean real estate developers aiming to manage their exposures to China's booming, albeit volatile, commercial property market quarterly returns.

One can also envision that an economic derivatives market with sufficient segmentation by region could become a way for domestic Chinese investors to take position on local economies without resorting to local residential real estate markets as an alternative of choice (thereby easing potentially damaging upward pressures on local property prices). Efficient risk management instruments will entail a more complete market which will be beneficial to all, Chinese and foreigners alike.

The US sub-prime crisis has exemplified the damages that a large economy's shortcomings can do to the rest of the world. Do we want to replicate the experience? Can finance learn from historians, and focus on real systematic risks including those stemming from the economy which is defining today the world of tomorrow at a headlong pace?

It should not be an issue of profitability for the exchanges or product sponsors, even though well thought- out instruments should attract global interest and trading volumes. It is actually a matter of common good that might impact everybody's life and economic welfare. At stake are our elders' retirement benefits, our children's and grandchildren's abilities to fund their studies, to find good jobs and sustain families of their own. Can we afford not to do it?

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