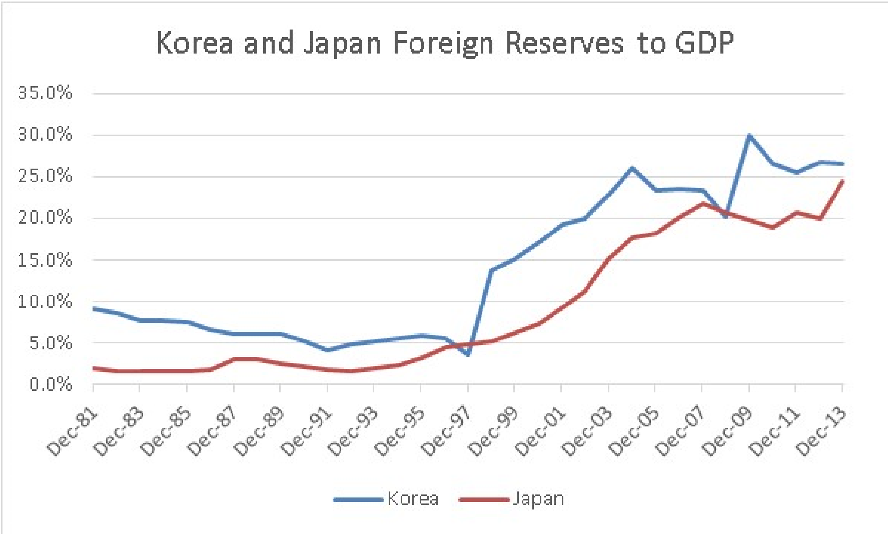
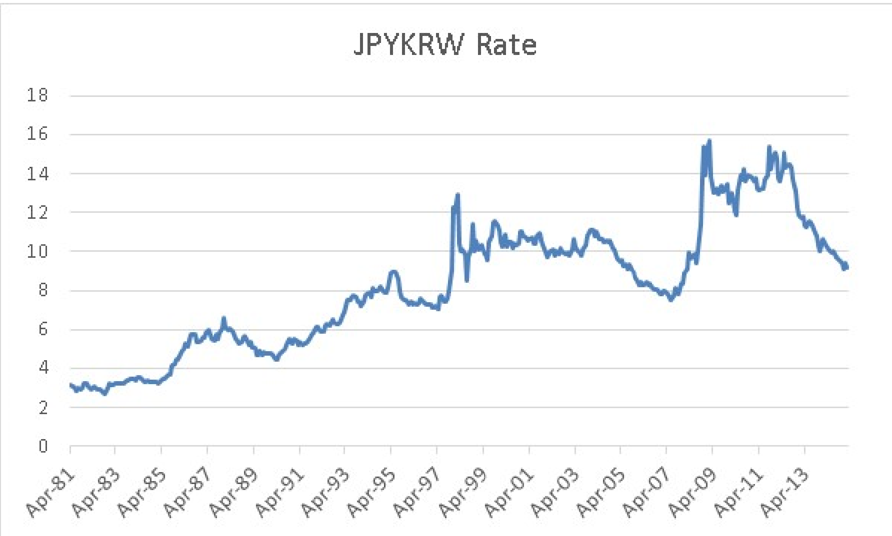
IS CHINA MORE LIKE KOREA THAN JAPAN?

In emerging markets it is commonly perceived that foreign reserves are an important stabiliser for a currency. Implicitly a country with large foreign reserves must have a more stable currency. Practical experience seems to imply that foreign reserves are not the only thing that matters.

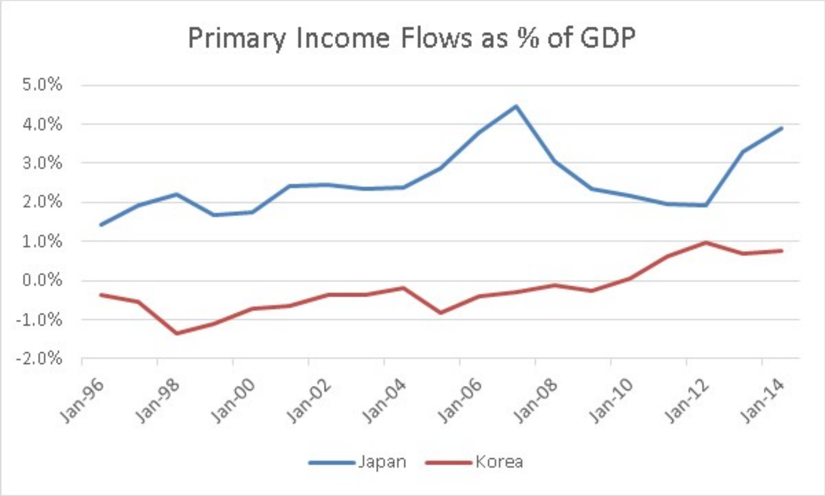


If we look at Korean and Japanese foreign reserves to GDP, we can see that Korea in general has a higher level of foreign reserves to GDP than Japan.

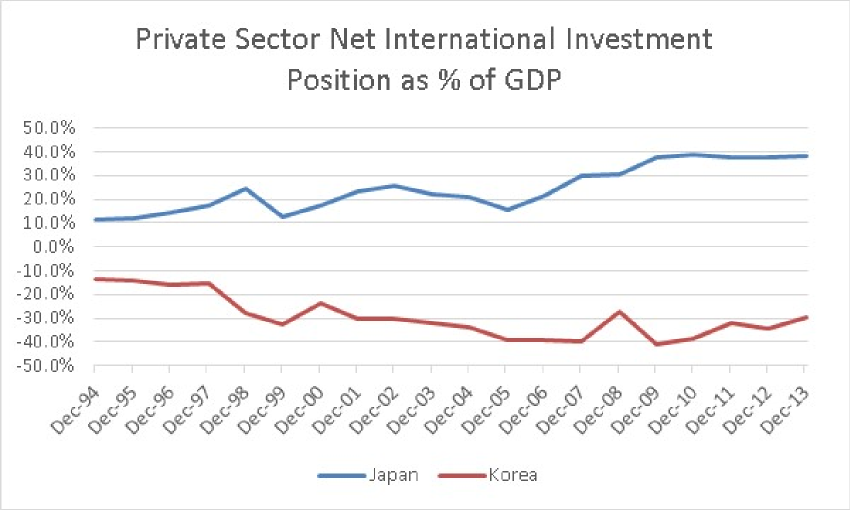


Despite having higher foreign reserves, the Japanese Yen has in general appreciated against the Korean Won, and particularly appreciated during the Asian financial crisis and the Global financial crisis. The higher levels of relative foreign reserves proved totally ineffective when needed most.

Fortunately, we are provided a hint as to why this might be from a bigger breakdown of Korean and Japanese current account data.

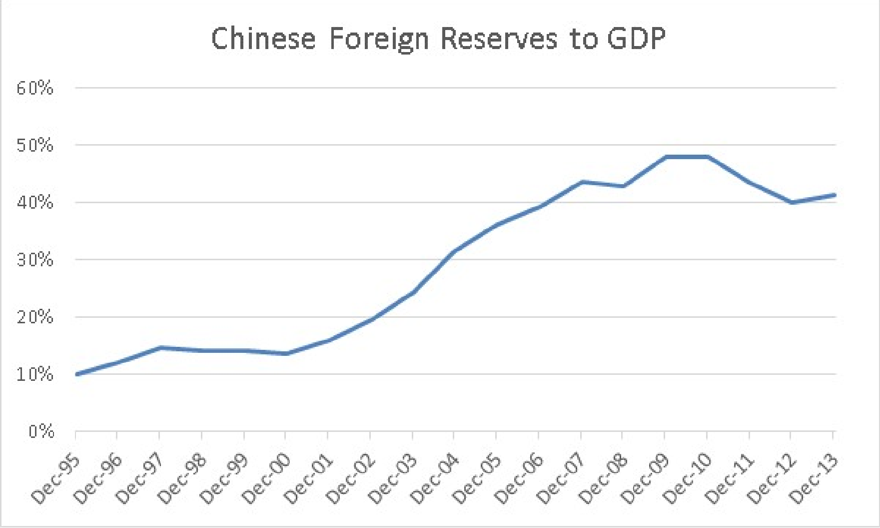


Net primary income is the returns generated on foreign assets less the amount earned by foreigners on domestic assets. Japan has been earning a return on its foreign investments for a significant amount of time, while the Koreans have only just begun to generate a return on their net investments. We can safely assume that Korean and Japanese foreign reserves hold very similar assets. The difference in these numbers come from the private sector net positions.



Intriguingly we can see a build-up in the private sector indebtedness prior to the steep devaluations in the Korean Won in both 1998 and in 2007. Conversely Japan companies being creditors to the world repatriate money in times of stress, leading to a strong Yen and weak Won.

If this analysis is correct, then what does it imply for China? Like both Japan and Korea it has very substantial reserves relative to GDP.



In fact its levels of reserves are larger than both Japan and Korea relative to GDP.

However its primary income is generally negative. Unfortunately, China only began publishing a net international investment position in 2011, so we cannot do a long term comparison of it private sector position. China lists its net investment position in September 2014 as USD 1.8 trillion. Foreign reserves at that time were USD 3.9 trillion, implying that the private sector has a net liability of USD 2.1 trillion, or roughly 20% of GDP.

When I see the negative primary income and a net liability position of the private sector in China of 20%, it seems to me that China is in a similar position to Korea in 1997. Investors should be prepared for potentially significant weakness in the Chinese Yuan.

INFORMATION

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