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China's monetary policy and trade in an age of great power rivalry

BY STEWART PATERSON
RESEARCH FELLOW, HINRICH FOUNDATION

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Foreword

On 4 February 2020, the US Administration added currency undervaluation to its existing criteria for the initiation of countervailing duty investigations, opening the door to the potential application of punitive tariffs on countries that manipulate their currency.

These measures, coming at a time when international trade and investment are becoming increasingly weaponized, have caused consternation within the multinational business community. However, they can be thought of as "push-back" against the Chinese Party-State's efforts to achieve economic suzerainty over other nations – specifically leveraging its monetary policy – while itself maintaining a non-market economic model.

China's monetary policy has not only influenced trade and investment growth in China, it has had global economic implications. To understand how, this paper examines the linkages between trade, investment, currency and exchange rates.

This paper provides an understanding of why investors and businesses engaged with China should expect a broadening in the scope of measures used to combat Chinese mercantilist policies, and why the US-China relationship is likely to become more "managed" at best, with the potential for more significant policies of disentanglement. It outlines the implications for global value chains and risks related to buying RMB assets.

Introduction

New measures linking currency undervaluation and tariffs have caused consternation.

On 4 February 2020, the US Administration added currency undervaluation to its existing criteria for the initiation of countervailing duty investigations, opening the door to the potential application of punitive tariffs on countries that manipulate their currency. The measures, coming as they do at a time when international trade and investment are becoming increasingly weaponized, have caused a certain amount of consternation.

This paper looks at the linkages between international trade and investment on the one hand and monetary policy and exchange rates on the other, particularly with regard to China. The accumulation of "hard currency" (mainly dollars) has played a major role in the economic transformation of China and its rise to regional hegemon as China operated on the Dollar Standard. Current account surpluses came to largely determine monetary policy.

The paper then considers the next phase of China's "National Rejuvenation". This may well require significant further foreign currency accumulation. China's desire to see the RMB achieve global reserve currency status has been constrained, in part, by the reluctance of its own citizens, let alone foreigners, to hold the currency in the absence of significant dollar-backing. The tightening of capital controls reflects this. Indeed, many Chinese policy initiatives, such as the creation of a central bank digital currency, the Belt and Road Initiative and the opening up of domestic capital markets to foreign investors can be viewed as attempts to shore-up the desirability and increase the use of the RMB in an effort to enhance seigniorage.

These measures push back against China's efforts to achieve economic suzerainty while maintaining an non-market economic model.

The policy announcement of 4 February, in conjunction with the tariffs imposed on Chinese imports and proposals, not yet adopted, to limit American investor involvement in Chinese capital markets and Chinese involvement in American capital markets, can be thought of as "push-back" against the Chinese Party State's efforts to achieve economic suzerainty, while maintaining an non-market economic model. For anyone who doubted the significance of Vice President Pence's speech at the Hudson Institute in October 2018, the latest policy measures should provide a moment of clarity. The United States views China as a strategic rival and for private sector businesses, that means it is certainly not "business as usual".

China's monetary policy in context

Establishing the credibility of the RMB through the Dollar Standard

In the early 1990s China was very much an emerging market.

In 1993, China accounted for just 4% of the world economy and 2% of global trade. That was also the last year in which China ran a current account deficit. The country had just USD27bn of foreign exchange reserves. Per capita GDP was below USD400, less than one-tenth of the world average. China was, in every sense, an emerging market economy, albeit one with huge latent potential given the size of its population.

Seigniorage is the difference between the cost of producing a bank note and the purchasing power of the bank note.

In almost all states, irrespective of political ideology, government enjoys a monopoly on the production of money – notes and coins. As has been said, "He who controls the supply of money controls the nation". This monopoly gives rise to seigniorage, the difference between the cost of producing a bank note and the purchasing power of the bank note. A few countries, such as Panama for example, eschew currency issuance and use a foreign currency such as the US dollar, which obviously, such countries cannot print themselves.

Commercial banks can create "near money", in the form of bank deposits, through lending. Since bank deposits are widely used as money, they are included in monetary aggregates such as M2 but not in narrower gauges of money such as M0. In China, nearly all commercial banks back in 1993 were state owned, so any seigniorage accruing to commercial banks ultimately accrued to the state anyway.

The RMB lacked credibility, thereby limiting seigniorage and national control over the economy.

The problem faced by all emerging markets is one of monetary credibility. By definition, emerging markets do not produce much that others want to buy, and this was certainly true of China in 1993; that is why they are called "emerging" markets. As a result, their currency has a limited use. Many of their own citizens, given a choice, would rather work in return for a "hard currency" rather than their own and it is not uncommon for a large part of an emerging economy to be "dollarized". Most estimates suggest there are over USD 1 trillion of US bank notes circulating outside the United States for this purpose. In the early 1990s a visitor to China would often be asked to pay for a taxi fare in dollars and receive a preferential exchange rate. Capital controls are an admission of the fact that given free choice, people would rather hold their wealth in a different currency.

Seigniorage, therefore comes firstly from law and coercion: forcing locals to use the state currency. Coercion has its limits and seigniorage is better achieved by instilling confidence among the population in the currency. That confidence comes from a long period of not abusing the powers of seigniorage by printing excessive amounts of currency or allowing one's banking system to create excessive amounts of local currency denominated bank deposits. "Excessive" here means such quantities that diminish the purchasing power of the currency through inflation. Zimbabwe perhaps represents the best modern example of a country that has rendered its currency worthless by abusing the power of seigniorage.

The ideal is to make one's currency acceptable overseas, beyond the jurisdiction of one's legal framework, and that requires a long period of confidence building. Switzerland, at the other end of the spectrum from Zimbabwe, without being a global hegemon, has created a level of confidence in its currency that provides it with enormous seigniorage. The Swiss franc has at times been considered almost an asset class. The United States, by virtue of being the dominant global economy and military power, achieved international status for the US dollar.

Accumulating large reserves of foreign currency to enhance the RMB credibility

To establish credibility for the RMB, the accumulation of foreign reserves became a policy target.

A short cut to enhance monetary credibility has been to accumulate large amounts of "hard currency" that can be held in reserve against the issuance of local currency. By linking the creation of local currency to the accumulation of a reserve currency that already has credibility, the credibility is transferred to the local currency. Hence for example, since 1983 Hong Kong has accumulated foreign exchange reserves to "back" the creation of Hong Kong Dollars. This has enhanced confidence that the rate at which Hong Kong Dollars can be exchanged for US Dollars will not fall. This has enabled, at times at least, companies and individuals to treat Hong Kong Dollars and US Dollars as fungible.

Not all emerging markets seek to go as far as Hong Kong did, and fully back the issuance of local money with US Dollars. However, most have set out to accumulate enough reserves of hard currency to demonstrate that they can pay for a number of months of imports and meet emergency funding requirements that might arise requiring the purchase of foreign goods.

This is not unique to China. Many emerging economies operate on a Dollar Standard.

Many countries operate somewhere in between the purely precautionary holding of US Dollars and the Hong Kong system of a pegged exchange rate, and explicitly link their exchange rate to the dollar and consequently foreign reserves play a major part in the domestic money supply and central bank balance sheet. This has become known as the "Dollar Standard".

The accumulation of foreign exchange reserves has therefore become a policy goal for most emerging markets. High levels of foreign exchange reserves instill confidence in the local currency. The existence of these reserves supports exchange rates helping lower domestic inflation and interest rates. This in turn supports economic growth and hence demand for local currency that enables the maximization of seigniorage. A virtuous circle can be created of faster growth and rising confidence.

Implications for the United States

The United States' trade deficit is the corollary of emerging markets' appetite to build foreign reserves.

US trade deficit

There is a ramification for America. If much of the rest of the world is intent on accumulating dollars through running trade surpluses, America must run a trade deficit. In return, the money is recycled back into dollar denominated assets of the purchaser's choice, usually Treasuries or agency debt. This can influence the allocation of capital in America. Whether this process has been beneficial or malignant is an ongoing debate.

China needed US dollars to finance imports and technology acquisitions.

China's economy in the early 1990s lacked capital, technology and expertise. A growing economy would require physical inputs from abroad: iron ore, oil and gas. The country's expanding population would require food imports too and these would all have to be paid for; not with RMB but with US dollars that would be acceptable to the seller. The transformation of China, the realization of the "China Dream" to rise as a regional and global power, would require the accumulation of foreign currency and particularly dollars.

There are, broadly speaking, two ways for a state to accumulate foreign currency. One is to sell assets to foreigners in return for their foreign cash. China had few assets to sell, other than raw land to foreign companies wishing to establish themselves in China. Furthermore, for an authoritarian regime desiring Communist Party control over its economy, foreign participation in the economy was undesirable except to the extent that it helped facilitate export earnings and/or useful technical knowledge transfer.

Running current account surpluses enabled China to earn dollars.

The second way to earn dollars is to run a current account surplus: to sell more goods and services than you buy. An undervalued exchange rate suppresses local demand for foreign goods and anyway, in China, many imports were prohibited. It also increases the competitiveness of locally produced goods abroad by suppressing the cost of local production.

Actions by China's central bank and impact on trade

Devaluation and perennial trade surpluses

The devaluation of the RMB in 1994 turned China's current account from deficit to surplus.

In early 1994, the Chinese devalued their exchange rate from RMB5.766/USD to RMB8.6/USD. The current account deficit of 1993 was turned into a current account surplus in 1994 and China has never run a deficit since. The exchange rate appreciated modestly in 1995 and was then held at RMB8.28/USD through to 2004. Chinese exports grew from USD75bn in 1993 to USD1.5 trillion in 2008 – a rise of twenty-fold. Foreign exchange reserves grew from just USD27bn to USD 2 trillion in 2008 an 80-fold rise.

Massive reserve accumulation followed from China's export success, import suppression and inbound FDI.

China's export success, and equally its ability to suppress domestic consumption of imports beyond that required for its export machine, together with foreign investment into China by MNCs, resulted in a huge accumulation of US dollars and other hard currency. This hard currency provided the backing assets for domestic monetary expansion. Exporters earned dollars. These dollars were converted into RMB to pay domestic bills such as wages and the law required surplus dollar earnings to be brought back to China.

Dollar reserves dictated Chinese money supply growth

The fixed exchange rate and capital controls facilitated this reserve accumulation.

Given the fact that exporters were earning many more dollars than were being spent on imports, the exchange rate should have experienced a rapid appreciation. Capital controls that limited the ability of holders of RMB, such as Chinese households, to sell those RMB for dollars should have further exacerbated the rise in the value of the RMB since there were effectively no sellers. Instead, to prevent exchange rate appreciation, the central bank bought the dollars at the prevailing targeted exchange rate. Hence, most of China's foreign currency earnings from trade and investment ended up in state, central bank-controlled reserves. The central bank bought the dollars from the banks that were acting on behalf of exporters with freshly printed RMB that were placed in the accounts held by the banks with the central bank. In other words, the liabilities that corresponded to the foreign reserve assets at the central bank were commercial bank reserves at the central bank.

Reserve assets in turn formed the monetary base in China thus dictating the pace of money supply growth.

As these commercial bank reserves at the central bank grew in line with foreign exchange reserves, banks could expend domestic credit. Hence, bank credit creation in China became intrinsically linked to foreign reserve accumulation. The central bank used the Reserve Requirement Ratio (RRR) to control the multiplier between loan growth by banks (and therefore deposit growth) and commercial bank reserves at the central bank. By linking broad money supply growth to foreign exchange reserve accumulation, the Chinese were building credibility in the RMB. The rapid accumulation of foreign exchange reserves allowed for rapid money growth which in turn fueled rapid economic expansion. A mercantilist approach to trade, viewing the external surplus as a measure of economic success, was therefore baked-in to China's growth model and its economic rise.

Dollar backing for the RMB gave the Chinese currency credibility.

By the early 2000s, no taxi driver in China would accept US Dollars. Such was the dollar earning power of the Chinese economy, the expectation had changed from one where the US Dollar was seen as a store of value, to one where the RMB was expected to appreciate against the dollar despite the rapid growth in the supply of RMB. China had achieved sovereignty over its money, in that domestically RMB was now universally acceptable.

But offshore wealth still commanded a premium by virtue of being beyond the reach of the Party-State.

An offshore dollar was a different matter, as wealth outside the country carried a premium for being beyond the reach of the authorities. The very different nature of China's political economy from that of the United States and the "free world" gave rise to a paradox. From a trade perspective, the RMB may well be very undervalued, or at least it certainly was for the 1990s and 2000s. However, that is not to say that, given free choice, many holders of RMB would not be willing sellers at this "bad" price. The arbitrary nature in which law is applied in China, and the pervasive nature of the Party-State meant that many private holders of RMB denominated wealth would gladly accept a large haircut on their wealth to put it beyond the reach of the Party-State by being offshore in a foreign currency and jurisdiction. This highlights the difficulty of economic interaction between a free market economy on the one hand and an authoritarian political economy where some elements of the market economy were expediently adopted, on the other.

A similar phenomenon occurred in Russia in 1998. The Ruble collapse occurred while the country was still a competitive producer of oil. It was the loss of confidence by the oligarchs in the regime and a sense that their wealth was under threat of sequestration that led to endemic capital flight. So far China has managed to avoid this fate, largely through draconian capital controls.

The main factor that prevented real exchange rates balancing the current account was China's huge under-utilized economic resources.

In economic theory, a fixed nominal exchange rate at an undervalued level does not guarantee export success over the long run, because monetary expansion through the current account surplus should lead to inflation in the surplus country and the real exchange rate should adjust to an equilibrium level.

There were a number of reasons why sizable, in fact unprecedented, Chinese money supply expansion did not lead to rampant inflation and a loss of competitiveness and has not yet – after 25 years – led to a current account returning to balance. Wages were tightly controlled and the urbanization of 20 million workers each year provided a fresh, seemingly inexhaustible supply of new labor. Resources had been so poorly allocated in the past that modest market-driven re-allocation led to rapid productivity growth that could absorb money growth without impacting prices. The banking system created money largely by allocating capital to supply increasing investment rather than demand increasing consumption.

Furthermore, the capital deepening from the bank funded investment (and FDI) further increased productivity. In addition, the PBOC sterilized some of the money creation by issuing bonds, limiting the impact of reserve growth on money supply. Finally, the level of undervaluation of the RMB to start with, coupled with the labor cost discount, was so great that the country was always going to have a long period in which to exploit its low-cost advantage. In fact, according to the BIS measure of the trade weighted real effective exchange rate, the RMB only appreciated by 20% between WTO accession in 2001 and 2014 when foreign reserves peaked.

Trade success exacerbated upward pressure on RMB and foreign reserve accumulation

Accession to the WTO produced such large trade surpluses that “dollar backing” for RMB rose from about 10% to 25% in seven years.

In 2001, China joined the WTO. The trade-driven monetary system continued but China’s export success was taken to a new level. Export growth accelerated to about 30% per year in the first six years after accession. By 2005 the upward pressure on the RMB was becoming unmanageable. The PBOC started to allow the RMB to appreciate against the dollar in a managed fashion. They also hiked the Cash Reserve Ratio from 7.75% to 18% to reduce the pace of M2 growth (reducing the money multiplier). The current account surplus rose steadily relative to the size of China’s GDP and exponentially in absolute dollar terms. From 1.3% of GDP in 2001, it rose to nearly 6% of GDP in 2005 and peaked at 10% of GDP in 2007. In the three years of 2006-2008 it averaged over 9% of GDP. USD1 trillion of foreign exchange reserves were added in those three years. As a result, the ratio of broad money outstanding to foreign exchange reserves fell from about 10 times in 2000 to under 4 times in 2008 – more than one quarter of RMB were backed by foreign exchange reserves – largely US Dollars. The “Red Back” was effectively a Chinese “Green Back”.

Source: bfishadow/Flickr

The global financial crisis and a change of direction

The global financial crisis marked a turning point in Chinese policy thinking.

Turning point for Chinese monetary system

The global financial crisis had a marked effect on Chinese policy makers. It also marked a turning point in the evolution of the Chinese monetary system. Firstly, it underscored in their own minds the superiority of their system and the flaws in Western capitalism. Secondly, it brought to an end the over-reliance on exports to the developed world as a means of earning hard currency; their main customers were now debt ridden and unable to spend in the same size as before. This in turn lead to a greater emphasis being put on the developing markets of Eurasia, Latin America and Africa as a destination for exports of which the Belt and Road Initiative is a manifestation.

As major economies adopted unorthodox monetary policy, China had both an opportunity and a requirement to pursue a more independent monetary policy.

From a monetary perspective there were a number of factors to take into account. With the United States and the Eurozone joining Japan in adopting unorthodox monetary policy, the threat of a rapid loss of confidence in the RMB was reduced. As other central banks broke taboo after taboo in efforts to stave off deflation and reinvigorate growth, the RMB looked more and more solid. From a starting point of very heavy foreign currency backing for RMB money supply, the money creation process could be, at least partially, de-coupled from foreign exchange accumulation. This gave the PBOC the scope to operate an independent monetary policy - independent that is from trade – and to worry less about the exchange rate credibility. This was necessary given the slowdown in the export sector from the diminution in demand for Chinese exports from the developed world and the declining returns on capital investment that was becoming more apparent in China.

With foreign reserves constituting the vast majority of the PBOC balance sheet a slowdown in the accumulation of reserves led to a slow-down in the pace of growth of the PBOC balance sheet. The slowdown in foreign reserve growth rate was driven as much by its huge base as anything else.

An independent monetary policy?

The dramatic slowdown in reserve accumulation, and then a fall in reserves, required a change in policy.

From 2004 to 2009 foreign reserves rose from USD600bn to USD2.4tn – an increase of USD1.8 trillion representing a four-fold rise in five years or a compound annual growth rate of 32%. From 2009 to 2014 they rose from USD2.4 to USD3.8 trillion – a USD1.4 trillion increase but a far more modest 58%, or 9.6% compound annual growth rate. Worse was to come. In the five years from 2014 to 2019 reserves fell from USD3.8 trillion to USD3.1 trillion – a 4% per annum shrinkage.

Monetary policy options following the GFC

Monetary contraction was not a policy option because the social and economic dislocation it would have caused would have threatened Party control.

Faced with the prospect of falling foreign reserves in 2014, the PBOC had two options: 1) Accept a shrinking balance sheet and the consequent shrinkage in the money stock. This would be deflationary and likely produce a contraction in nominal GDP. This in turn would have almost certainly led to social chaos and potentially the over-throw of the political system; 2) Substitute an alternative asset for foreign assets by expanding the balance sheet independently from the trade and investment driven foreign asset accumulation. This would enable the PBOC to pursue the Communist Party's primary aim of power retention through social stability and growth. However, it would also potentially run the risk of reducing the appeal of the RMB and, if abused, potentially a loss of credibility for the currency.

China's monetary policy choices

The PBOC expanded the monetary base by buying bonds and relaxing the RRR to allow banks to expand broad money independent from reserve accumulation.

The PBOC opted to adopt a policy of relatively modest balance sheet growth driven by open market operations (buying bonds to create bank reserves) and simultaneously to reduce the Cash Reserve Ratio so that the PBOC balance sheet could be leveraged more by the banking system. The ratio of M2 to M0 could expand to compensate from the slower growth of M0. They continued however, to try to operate a controlled exchange rate regime. In other words, they have been over the past 5 years or so been trying to control money supply, interest rates and the exchange rate at the same time, balancing domestic goals of growth and low inflation, with external exchange rate stability.

The Chinese economy, however, is facing headwinds. The state-run financial system is not allocating capital particularly efficiently. The incremental output ratio, the amount of economic growth coming from a unit of investment, has deteriorated. The tightening of political control over the economy under President Xi, a reversal of the liberalization of the past, coupled with "un-backed" monetary expansion, led to capital flight – much of it illegal. Despite the fact that the international monetary environment could not have been more accommodating, China has found herself in a classic dilemma.

Deteriorating economic fundamentals mean more money creation is required for every unit of growth. But high levels of money creation lead to capital flight in the absence of tighter capital controls.

Slowing economic growth is producing financial instability and threatens societal harmony. The legitimacy of the Communist Party rests on delivering higher living standards year in and year out. Monetary expansion aimed at driving growth higher has lost much of its efficacy and therefore more and more money has been required to achieve the desired effect. Yet the more money that is created, the less credibility the money carries and therefore the more people might wish to sell the RMB and move into hard currency. Between 2014 and 2017 China lost about one quarter of its foreign exchange reserves, which were spent defending the value of the currency in face of capital flight. As a result of both the exchange reserve losses and the monetary expansion associated with trying to generate economic growth and therefore political legitimacy, the ratio of China's M2 to foreign exchange reserves has risen from 4.6 times in 2013 to 9 times now, the same level as in 2001, prior to WTO accession.

American policy challenges

Trump push back against Chinese mercantilism

US push-back against Chinese mercantilism is making it harder for China to earn dollars.

When least wanted from a China perspective, President Trump, in 2018, began to act on his election promises of 2016. The upshot of the tariff war has been to make it harder for China to earn US dollars through trade. This does not mean the Chinese will not be able to earn them. Terms of trade movements such as commodity price deflation (China is a big importer of commodities) may well help China in the short run. But it seems unlikely that the large current account surpluses of the mid 2000s will be tolerated again – at least not by the United States.

China is looking to liberalize capital inflows to obtain dollars through the capital account.

This has led to a refocusing of Chinese policy. If dollars cannot be earned in sufficient quantities through the current account, can they be earned through the capital account? Foreign institutional investors have been highly restricted in their ability to buy RMB denominated financial assets and where they have been able to do so, there has been a reluctance to buy them. It is one of the paradoxes of economics that a competitively priced currency that produces a trade surplus is also attractive to foreign capital because it holds out the potential for capital gains through appreciation. Similarly, a country not producing trade surpluses might not prove a good investment destination for foreign portfolio capital. In other words, they tend to reinforce and double up an existing trend, not act as a counterbalance to it.

It is in this context that recent US policy measures need to be viewed.

It is through this prism – of China trying, but struggling, to break away from the Dollar Standard, with a relative dearth of reserves and a slowing growth rate in the economy, with an inefficient capital allocation mechanism and a bloated stock of credit – that recent and proposed policy measures by China need to be viewed. Moreover, it is against a background of United States pushing back against the efforts of China to establish its economic suzerainty, while retaining a non-market economic system and authoritarian political system, that the current US Administration's policy choices should be viewed. Those involved in trade with China therefore find themselves pawns in a geo-economic struggle that is unlikely to end soon.

Redefining US-Sino economic engagement: Controlled trade or disentanglement?

Between China's WTO accession and 2018, US policy makers have largely let the US-China economic relationship develop without interference.

In the eighteen years between Congress granting China Permanent Normal Trade Relations (PNTR) in 2000 paving the way for China's accession to WTO, and the imposing of tariffs by the Trump Administration in 2018, US policy makers have interfered very little in the economic relationship between China and the United States. Other than the odd high-profile intervention by CFIUS, US involvement in China's economy has been determined by the actions of profit maximizing private companies acting in self-interest and by consumers expressing their sovereignty at the check-out till.

Chinese policy makers on the other hand have been active in molding the economic engagement to further China's national interests.

The same cannot be said of China. Inbound FDI has been restricted, with large parts of the economy off-limits, and has often been conditional. Market access has not been on a reciprocal basis and imports have been relatively heavily tariffed. Chinese policy makers have exerted control over which Chinese companies can raise capital abroad and controlled foreign access to domestic capital markets. Overseas earnings, the acquisition of which has been a policy priority, have ended up in state hands through the control of the exchange rate.

The result of this asymmetry in approach, has been that the depth and nature of the economic entanglement between the United States and China has been determined almost entirely by Chinese policy and, unsurprisingly perhaps, there is a growing recognition that benefits have not been evenly spread.

The Trump administration has woken up to the asymmetry of the relationship.

The Trump administration's China policy marks a sharp departure from that of its predecessors. With China under President Xi moving further away from the liberal economic order, not converging with it (as was hoped), the US Government is playing a greater role in shaping the nature of the economic relationship. The US is operating under the belief that it can re-engineer the relationship to work in the US national interest or, failing that, scale the relationship back to a level that: a) reduces Chinese leverage; b) removes the more debilitating aspects of the relationship; and c) potentially exerts pressure on China to reform.

Given the linkage between trade, investment, currency and exchange rates it is logical to assume that a policy aimed at redressing the imbalance will address not just trade but all aspects of the interaction.

As was explained earlier, the linkage between trade, investment and currency encompasses the entire China-US economic relationship: China's exchange rate policy drove trade flows, investment flows and money creation. It is therefore natural that in response to a change in attitude towards trade policy we should expect changes in investment policy.

The opening of China's capital markets and the digital RMB are policy areas that will likely attract policy makers' attention.

Against the background of a more proactive American policy towards the economic relationship, China is pursuing two important policy initiatives aimed at enhancing the attractiveness of the RMB and increasing her leverage over the global economy: 1) Opening up its capital markets to foreign investors to attract dollars; and 2) Initiating a digital central bank currency to increase the utility of the RMB as a means of exchange with the long term potential of supplanting the dollar's dominant role in international transactions.

These two initiatives will bring into sharp focus the type of economic relationship the US wishes to have with China going forward and the lengths the US is prepared to go to in order to shape that relationship.

China's "National Rejuvenation" - monetary implications

Capital market opening in China – A Trojan horse?

The rise of passive investing presents China with an opportunity to attract billions of dollars of "blind" capital.

The rise of "passive investing" – buying ETFs or funds that track a stock market index, as opposed to actively allocating capital based on judgement – has presented China with an opportunity to attract foreign capital. If Chinese assets are included in widely followed indices, then the managers of funds that are supposed to track those indices will have no choice but to buy those Chinese assets. It is therefore unsurprising that China is keen to influence companies that compile and provide these indices to include Chinese assets in them. From a trade perspective, it is important to note that these flows will take place in isolation from any rational assessment of the underlying competitiveness of the currency.

Foreigners own about 3% of Chinese financial assets at present.

The numbers are not small. About half of the USD8 trillion US mutual fund industry is passive. More importantly nearly all actively managed money pays some attention to a benchmark. It is a brave fund manager who ignores a market entirely if it constitutes a part of its fund benchmark – the yard stick against which performance is measured. Foreigners own about USD500bn of Chinese financial assets, yet China's equity market capitalization is about USD9 trillion and her bond market is about USD13 trillion. In other words, foreigners own less than 3% of China's financial assets. This is exceedingly low by international comparison. For example, foreigners own about 40% of the Indonesian bond market (a high level) and it is not uncommon for foreign ownership in equity markets to be in the order of 20-30%.

If this were to rise to 10%, foreigners would have to pour about USD1.2 trillion into China.

The key point is that if the Chinese capital market indices are included widely in global benchmarks, the ability of the Chinese to attract between USD100bn and USD200bn a year in capital inflows is very real. A rise in foreign ownership from less than 3% to 10% would bring in perhaps USD1.2 trillion over time. This would correspond to a roughly 50% increase in foreign reserves. An increase in foreign ownership to 20% would bring in USD3.2 trillion and double reserves. To what end?

The sharp fall in China's foreign reserves between 2014 and 2016 has provided food for thought in Beijing. To what extent was the capital flight driven by a loss of confidence by the owners of wealth in China that their assets were safe? Was it in effect a vote of no-confidence in President Xi, driven by fear of sequestration and his anti-corruption campaign? Or, was it in fact driven by the laws of economics? China's money stock had become too big relative to the cash flows the economy was producing and therefore better returns were to be had elsewhere. Either way the response has been a severe tightening of capital controls.

Foreign capital inflow would increase the dollar-backing of the RMB and help facilitate China's economic expansion into Eurasia.

One of the ramifications of the need for greater caution in allowing capital outflows, has been a slowdown in the "going out" process – the internationalization of China's SOEs and the opening up of new markets in Eurasia and beyond, via the Belt and Road Initiative. Chinese SOEs own over USD1 trillion of overseas assets as part of their strategic expansion. Although, it is worth noting, that while foreign exchange reserves fell by USD 1 trillion, SOEs were building their offshore assets. China's overall net international investment position has continued to improve modestly.

If China can attract passive and benchmark-hugging portfolio flows, it could have two dramatic effects. Firstly, it would result in significantly more hard currency backing for its bloated money supply, restoring credibility in its currency. This could help alleviate the current constraint on domestic monetary expansion. Secondly, it would enable a renewed attempt to internationalize the RMB and secure new markets for her exports along the new Silk Road. In effect, in return for selling minority stakes in listed companies to foreigners and, even better, getting foreign investors blindly to buy Chinese debt, much of which is non-performing, the Communist Party of China (CPC) could re-energize their efforts to cement a sphere of influence in Eurasia and beyond. Furthermore, minority ownership of Chinese companies and debt would carry no leverage for foreign investors while potentially subjecting them to losses and therefore make them unwittingly subject to CPC influence. The CPC would create another constituency within the West whose interests would be more closely aligned with their own.

The digital RMB and enhanced seigniorage

The internationalization of the RMB is a core part of China's push for global economic hegemony.

The process of Sinification in the Eurasian hinterland of China is a strategic goal and forms part of the "National Rejuvenation" of China. The internationalization of the RMB is part of the same geopolitical strategy. As noted earlier, the ultimate test of a currency's credibility is its ability to gain acceptance as a means of payment and store of value beyond the jurisdiction of the issuer.

As China has become the most important trading and investment partner for a large number of countries, and as the Chinese economy has grown in terms of the range and quality of products it produces, it is natural that the acceptability of the RMB should rise. Since 2009, China has pursued a policy of trying to internationalize the RMB with the aim of enhancing seigniorage and reducing its dependence on US Dollars. Some official recognition of this process came with the inclusion of the RMB by the IMF in the composition of Special Drawing Rights (SDRs). So far, this policy has met with limited success. About 40% of international transactions remain dollar denominated with the Euro accounting for a further third. The RMB is only used in about 3% of international trade transactions.

The digital RMB is designed to increase the use of the RMB in China's sphere of influence.

The major barrier to the internationalization of the RMB remains the closed nature of china's capital account which in turn is a function of the CPC's desire to control the commanding heights of the economy and the allocation of capital. With this in mind, China is on the cusp of trialing its own digital currency. Unlike alternative digital currencies such as Bitcoin, the digital RMB will be RMB – i.e. 100% fungible with paper RMB. Its virtue is potentially the convenience and low cost of its use. It could, depending on how it is structured, increase the seiniorage accruing to the state by by-passing the banking system. Individuals, companies and importantly foreign states, could end up having accounts with the central bank rather than retail banks which would by-pass credit risk associated with holding deposits in a highly leveraged financial system. This could dramatically increase the control the central bank has over the money supply (although in China where banks are largely state owned and respond quickly to the wishes of the central bank anyway this virtue may not be so great). It could also act as an international payments system putting the PBOC at the heart of an RMB denominated trade finance system.

Challenges ahead

Next steps for US policy

Washington has become more united in pushing back against China's mercantilism.

In some ways President Xi has achieved the unimaginable by producing something of a bipartisan consensus in Washington that there cannot be a return to the ex-ante status quo with regard to the US relationship with China. There is, however, no consensus on where America goes from here. The questions for debate now appear to be more around the appropriate level of government interference in determining private sector engagement with China. Is it, for example, a legitimate role of the US government to restrict American investor access to shares traded on Chinese stock exchanges? Should American companies have the right to pass intellectual property to Chinese counterparts in return for market access if that IP has been in part funded by US taxpayers? Should US academics who receive US government grants be allowed to work part time for Chinese universities or companies?

Further policy measures are likely to shape the China-US relationship - either to make it more reciprocal or to roll it back through disentanglement.

While these micro questions are important, the bigger questions are what sort of economic relationship with China is compatible with US national interests and what sort of constraints on US citizens are acceptable to achieve such a relationship? At what point would the adoption of such policies turn America into the very creature against which it is supposed to be pushing back? While there will undoubtedly be costs associated with a policy of disentanglement, and it might be the case that they are too high to justify, is now the opportune moment to allow American financial institutions to buy a trillion dollars or more of Chinese financial assets? Perhaps not.

More challenges ahead for business

Businesses should expect further changes in the nature of Sino-US economic relations.

With the impending digitalization and internationalization of the RMB, now would seem a good time to debate the role of the US Dollar as a global reserve currency, its benefits and costs. Without proper cost-benefit analysis, how do we know how vigorously or not to defend the role of the dollar? The Dollar Standard after all, has materialized over time and is not a product of state policy. Does it bestow upon the United States an "exorbitant advantage" as Giscard D'Estang thought or has it been responsible for the hollowing out of American industry and the destruction of the middle class? If you do not know where you want to end up, any road will get you there. Whichever direction the economic relationship between the US and China takes, disentanglement or greater symmetry, the ex-ante status quo of two years ago is unlikely to return. Business engaged with China need to be aware of, and prepare for, the likelihood of further change.

Researcher Bio: Stewart Paterson

Stewart Paterson is a Research Fellow at the Hinrich Foundation and the author of "China, Trade and Power: Why the West's Economic Engagement Has Failed". Paterson has been following the Chinese economy since 1991. After a stint in London and Mumbai, he lived in Hong Kong from 1998 to 2007 working firstly for CLSA as Head of Global Emerging Market Strategy and then for Credit Suisse, as Managing Director and Head of Asia-pacific Strategy. He then moved to Singapore in 2007 to co-found the eponymous Riley Paterson investment Management. He now lives and works in the UK. He holds a Master's degree in Economics from the University of Aberdeen.

Stewart Paterson

Research Fellow
Hinrich Foundation

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MEDIA INQUIRIES

Ms. Berenice Voets,
Director of Public Affairs
T: +852 9081 8210
berenice.voets@hinrichfoundation.com

Contact us to discuss research partner opportunities or education initiatives. Join us in advancing sustainable global trade by following us on social media.
inquiry@hinrichfoundation.com

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