

The Challenges and Opportunities for the Chinese Economy

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Introduction:

The Challenges and Opportunities

◆ Challenges:

- ◆ The COVID-19 Epidemic (under control)—growth of almost 3% in 2020; average of 6% per annum through 2030;
- ◆ China-U.S. Economic, Technological and Geo-Political Competition (continuing “new normal”)—will probably last for a decade or longer;
- ◆ Continuing Economic Reform and Opening (The Twin Circulations)—with the focus on domestic circulation.

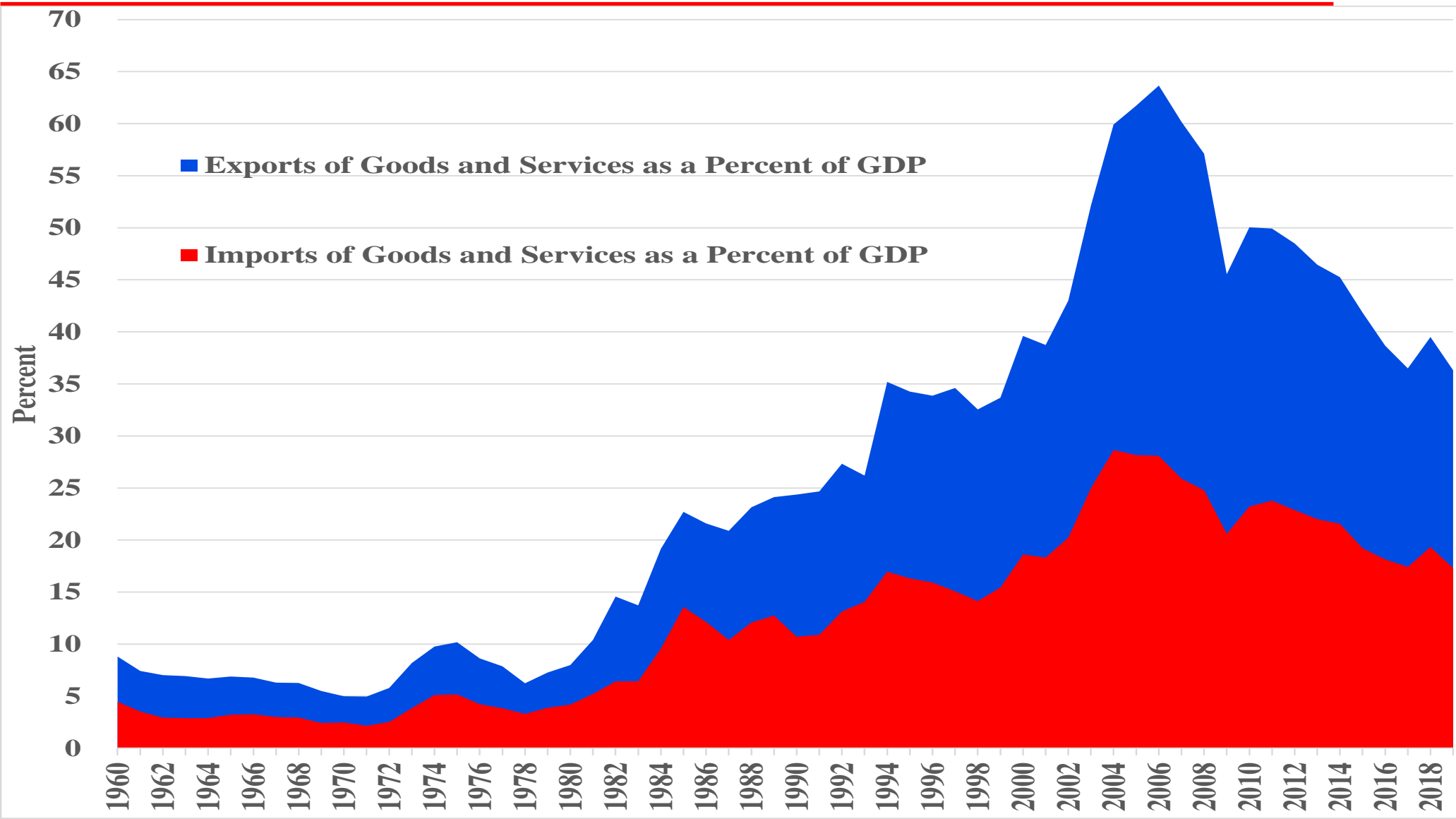
◆ Opportunities:

- ◆ Assisting Other Countries in Controlling the COVID-19 Pandemic (Chinese vaccines)
- ◆ Providing Leadership in the Prevention of Further Climate Change

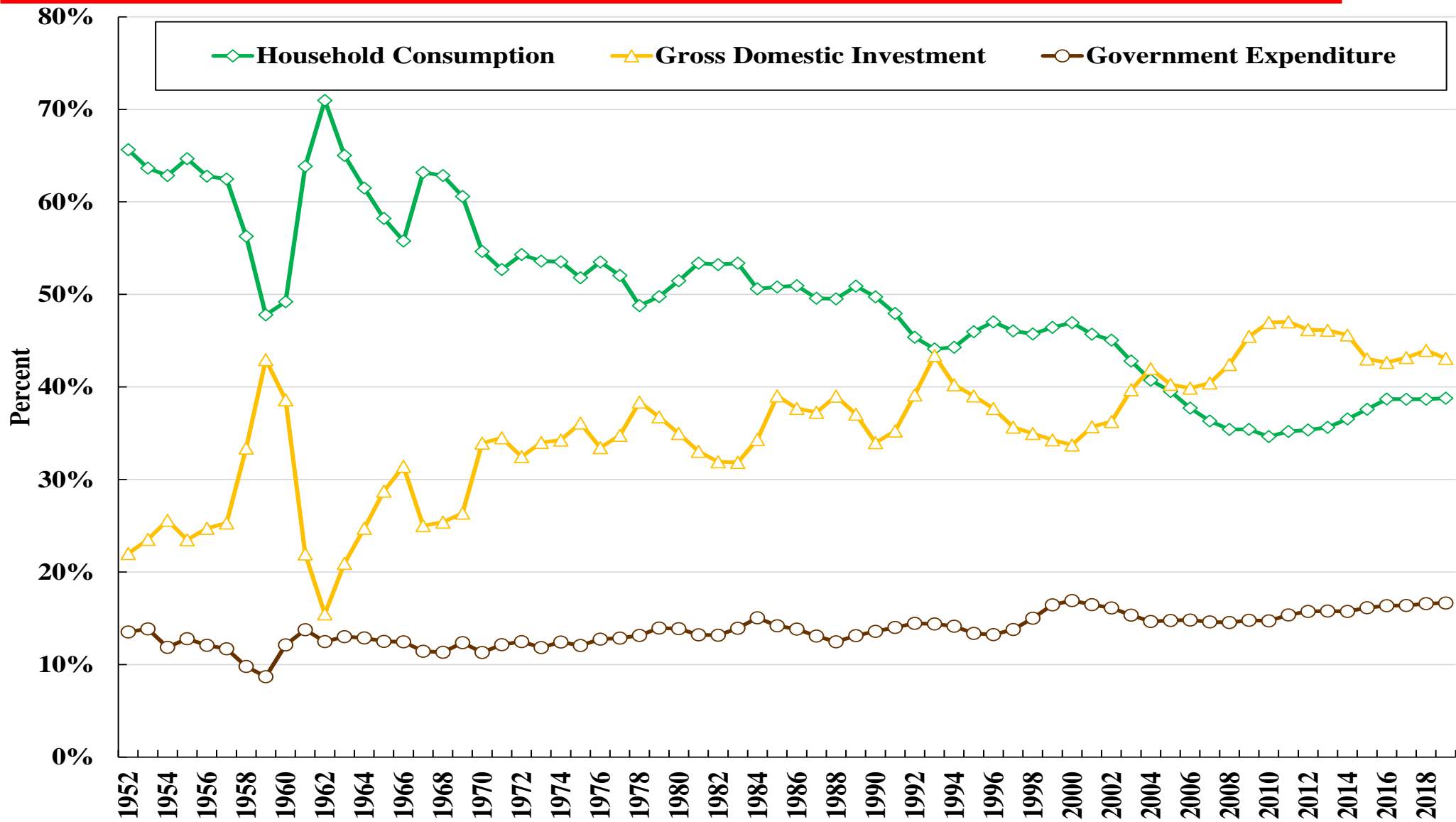
Continuing Economic Reform and Opening: The Twin Circulations

- ◆ In August 2020, President XI Jinping of the People's Republic of China said, "China should promote the formation of a new pattern of economic development, with the domestic circulation as the principal focus, and the twin domestic and international circulations mutually reinforcing each other". This shows clearly that China's intention is to remain an active participant of the global economy, even though the domestic economy will become the dominant focus of its economic development. It is simply a reflection of the fact that the Chinese domestic market will exceed its international market, which is normal for large continental economies like China and the U.S.
- ◆ On 14 October, during the celebration of the 40th Anniversary of the establishment of the Shenzhen Special Economic Zone, President XI Jinping reaffirmed once again that China will continue its economic reform and opening.
- ◆ It is therefore clearly in China's interests that the global financial systems continue to enable and facilitate international trade and other cross-border transactions.

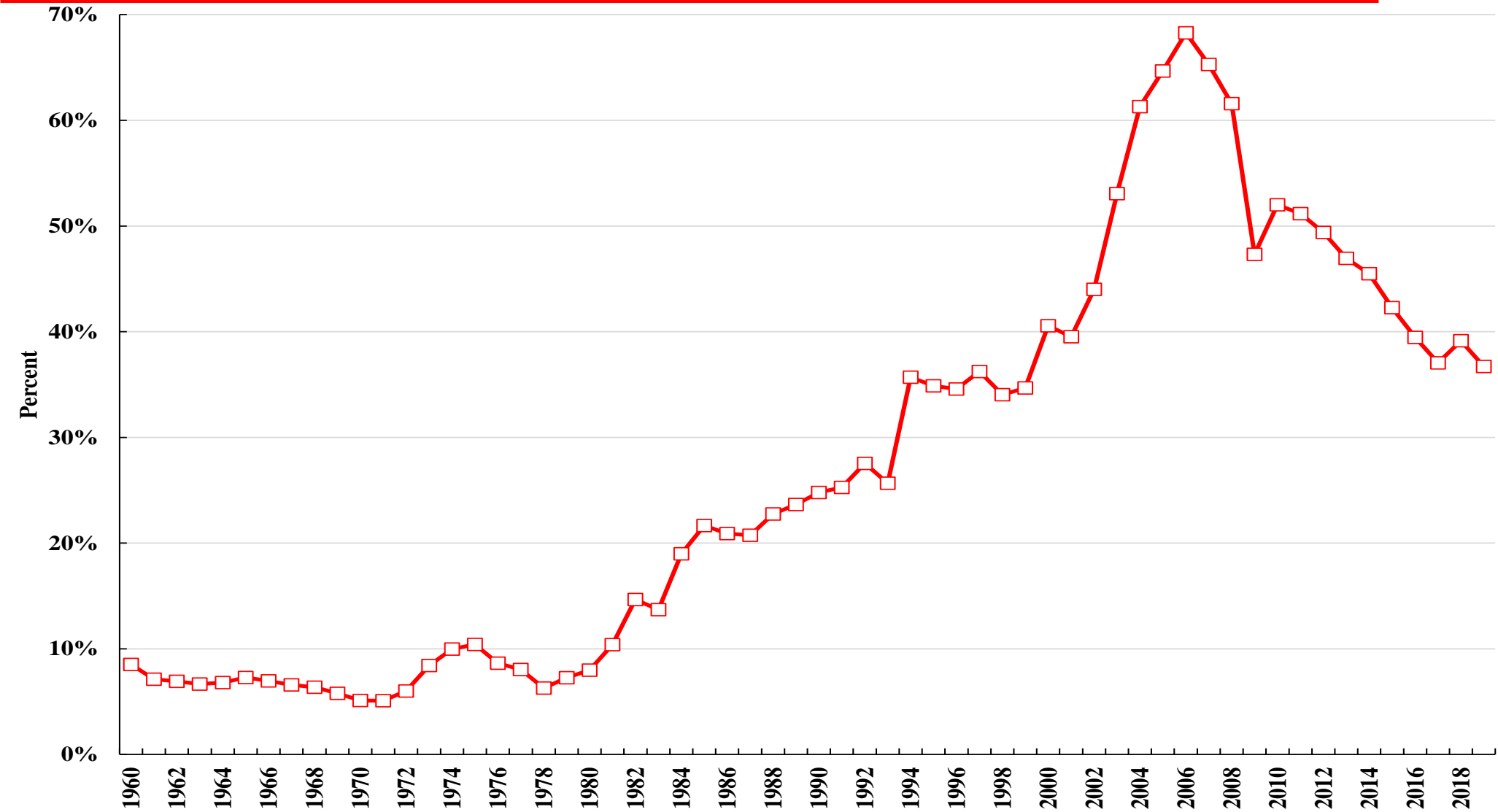
Chinese Exports and Imports of Goods and Services as a Percent of GDP, 1960-present



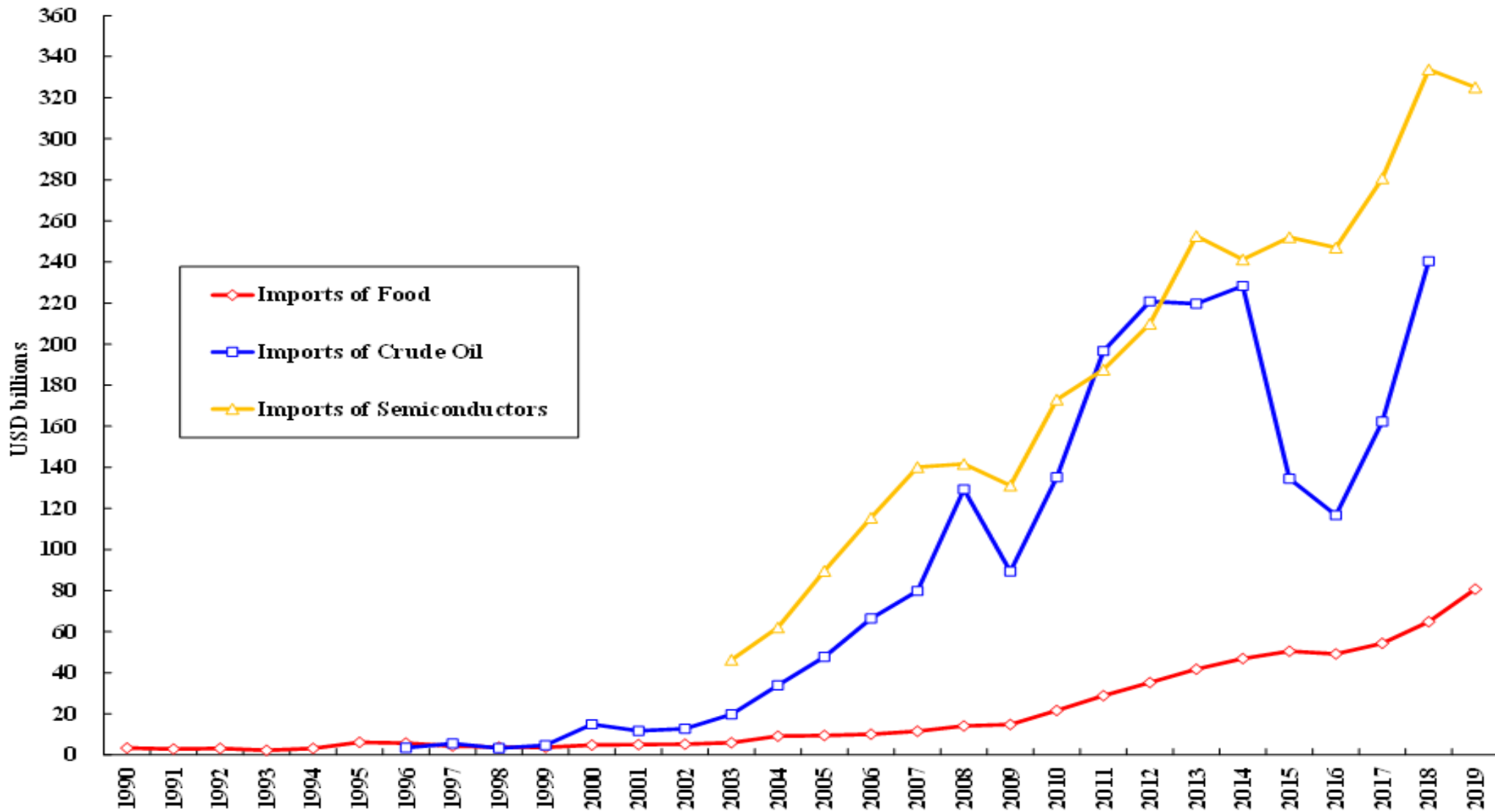
Household Consumption, Gross Domestic Investment, and Government Consumption (%)



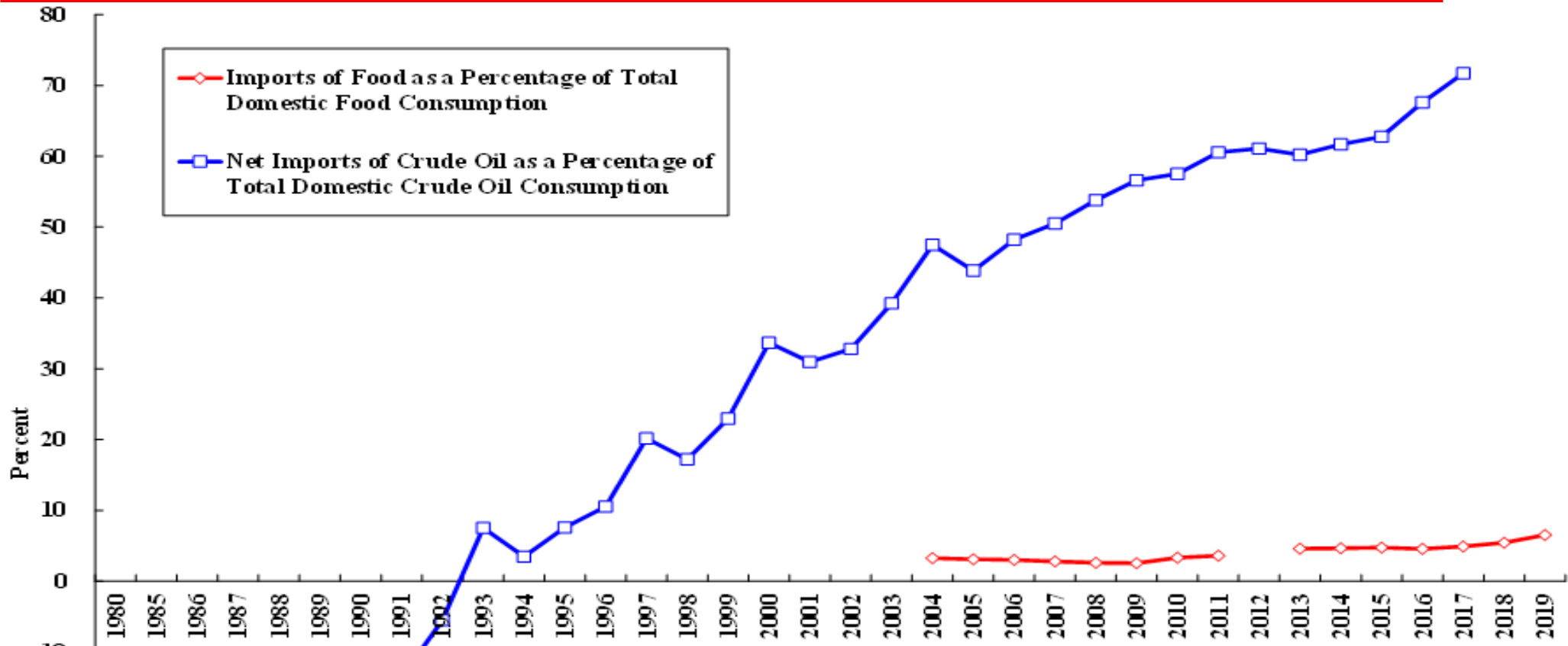
The Ratio of International Circulation to Domestic Circulation (percent)



Values of Imports of Food, Crude Oil and Semiconductors, US\$ billions



Imports of Food and Crude Oil as Percentages of Total Domestic Consumption



Sustainability of the Twin Circulations

- ◆ The potential impacts of possible blockages of imports of critical commodities can be mitigated through appropriate diversification of the sources of supply. Food, oil and metal ores are widely available in the world—appropriate diversification of the sources of imports provides the insurance against unforeseen interruptions of supply.
- ◆ However, the bans on the exports of critical products such as advanced semiconductors and semi-conductor manufacturing equipment to China from the U.S. or other countries poses a serious challenge as they cannot be easily mitigated in the short run. This is indeed a “Sputnik” moment for China, as it was for the U.S. when the former Soviet Union launched the first man-made satellite into orbit in 1957. It calls for accelerated indigenous innovation to achieve break-throughs in these industries. It will take significant investment and time. China must become self-reliant in these critical industries.

Sustainability of the Twin Circulations

- ◆ In critical core technologies, self-reliance is actually the rule rather than the exception. The former Soviet Union, France, China, India, Pakistan and North Korea all developed their individual nuclear-weapon capability indigenously, without any foreign assistance.
- ◆ China was able to develop the atomic bomb successfully in 1964, when the country was still very poor, with a per capita GDP less than US\$200 in 2019 prices. Today, Chinese GDP per capita is over US\$10,000, and China has ample supply of scientists and engineers. It should be able to find solutions for securing the supply of advanced semiconductors and semiconductor manufacturing equipment on its own.
- ◆ Moreover, there is often more than one way to accomplish the same objective. In the cold war arms race between the U.S. and the former Soviet Union, each had its own comparative advantage. The U.S. was good at miniaturization, and so its rockets did not need to be so powerful. The former Soviet Union had much more powerful rockets and did not pursue miniaturization. However, both of them were able to threaten each other with “Mutually Assured Destruction (MAD)” through their nuclear-armed missiles, preventing a cold war from becoming hot.

Sustainability of the Twin Circulations

- ◆ Similarly, Huawei may not be able to produce its cell phones without the advanced semi-conductor chips that U.S. would not allow any firm using U.S. equipment or technology to supply. However, by taking advantage of the enormous speed of 5G (or even 6G) telecommunication, the Huawei cell phone can function as a terminal or front end with all the applications and data stored in a cloud. The cell phone can essentially be just a screen. Once more, miniaturization per se is no longer an absolute requirement.
- ◆ Quantum computers, for example, the “liuzhang” supercomputer, which relies on photon communication, is vastly faster than conventional ones. It is faster than the third fastest super-computer in the world, the TaihuLight, built by China.
- ◆ There also appears to be some progress in the development of graphene-based rather than silicon-based semiconductors which can reduce the need for advanced equipment for high-precision etching and lithography.

Continuing Economic Reform and Opening: Economic Globalisation

- ◆ Economic globalisation has brought great benefits to the entire world since the 1950s. China owes its economic success in the past four decades in large measure to economic globalisation. However, further economic globalisation has been stalled by the recent rise of isolationism and protectionism around the world, and the situation is exacerbated by the COVID-19 pandemic.
- ◆ When two countries trade, their sets of consumption possibilities are enlarged. Consumption choices that are previously unattainable will become feasible. Thus, the welfare of both countries in the aggregate cannot decrease and in general must increase.

Continuing Economic Reform and Opening: Economic Globalisation

- ◆ However, the benefits have accrued to each country as a whole; but unfortunately, trade will also create both “winners” and “losers” within each country. The “winners” are the exporters, importers, the producers of export products, and their owners and workers, and the consumers and users of imports; and the “losers” are the owners and workers of the industries the products of which are displaced by imported competition.
- ◆ Even though trade actually generates enough gains in each country so that in principle everyone in both countries can be made better off than before, the benefits accrue to each country in the aggregate, and the free market can and will only reward the “winners” but cannot compensate the “losers”. It is the responsibility of each government to redistribute part of the gains of the “winners” to the “losers” in its own country through transfer payments and re-training and re-employment programmes.

Continuing Economic Reform and Opening: Economic Globalisation

- ◆ But very few governments have done so adequately. It is the failure, over a long period of time, of governments to compensate the “losers” from economic globalisation that has led to the rise of populism, protectionism and isolationism worldwide. Today, the “losers”—the people who have been left behind by economic globalisation all these years—want to reverse economic globalisation, put up trade barriers and to try to bring the lost jobs back.
- ◆ China has done an excellent job in making sure that there are no “losers” in its economy. Everyone in China old enough will acknowledge that he or she is much better off than in 1978, more than 40 years ago. China will have eliminated poverty according to Chinese standards by the end of 2020.
- ◆ It is China’s intention and plan to continue its economic reform and opening in the future.

Continuing Economic Reform and Opening: Economic Globalisation

- ◆ However, if economic globalisation benefits both trading-partner countries, any economic de-globalisation that results in a reduction in international trade, whether through tariffs or export controls, harms both countries. Economic de-globalisation is therefore lose-lose for every country, because the choice set of every country is reduced.
- ◆ Tariffs and export controls can be imposed for allegedly national security reasons. However, one has to accept that critical products, processes and technologies will be carefully guarded by all countries for national security as well as commercial reasons. That is why any major power will have to be self-reliant on critical products, processes and technologies, or at least to develop or find a second source¹⁵.

Continuing Economic Reform and Opening: Economic Globalisation

- ◆ However, once a second source is available, export controls no longer serve any useful purpose but instead harms the country's own firms. Thus, international trade should be allowed to resume.
- ◆ It is likely that there will be at least two 5G telecommunication systems in the world. And there are already at this time at least three functioning positioning systems in the world—The Global Positioning System (GPS) of the U.S., the Galileo Satellite Navigation system of the European Union, and the Beidou Satellite Navigation system of China.
- ◆ The availability of at least a second source is actually beneficial for the world as a whole because it reduces the monopoly power (and price) of any country or firm prevents the use of the threat of exclusion. In addition, the redundancy can alleviate the risks of a catastrophic failure of one of the sources.

Continuing Economic Reform and Opening: Specialisation and Economic Interdependence

- ◆ Specialisation of individual economies and the division of labour among them will contribute to the increasing concentration of the production of different goods in different economies, based on their respective comparative advantages and benefitting everyone.
- ◆ This also means much greater economic interdependence among the different countries, which should make it less likely for them to go to war.

Continuing Economic Reform and Opening: Initiatives and Strategies

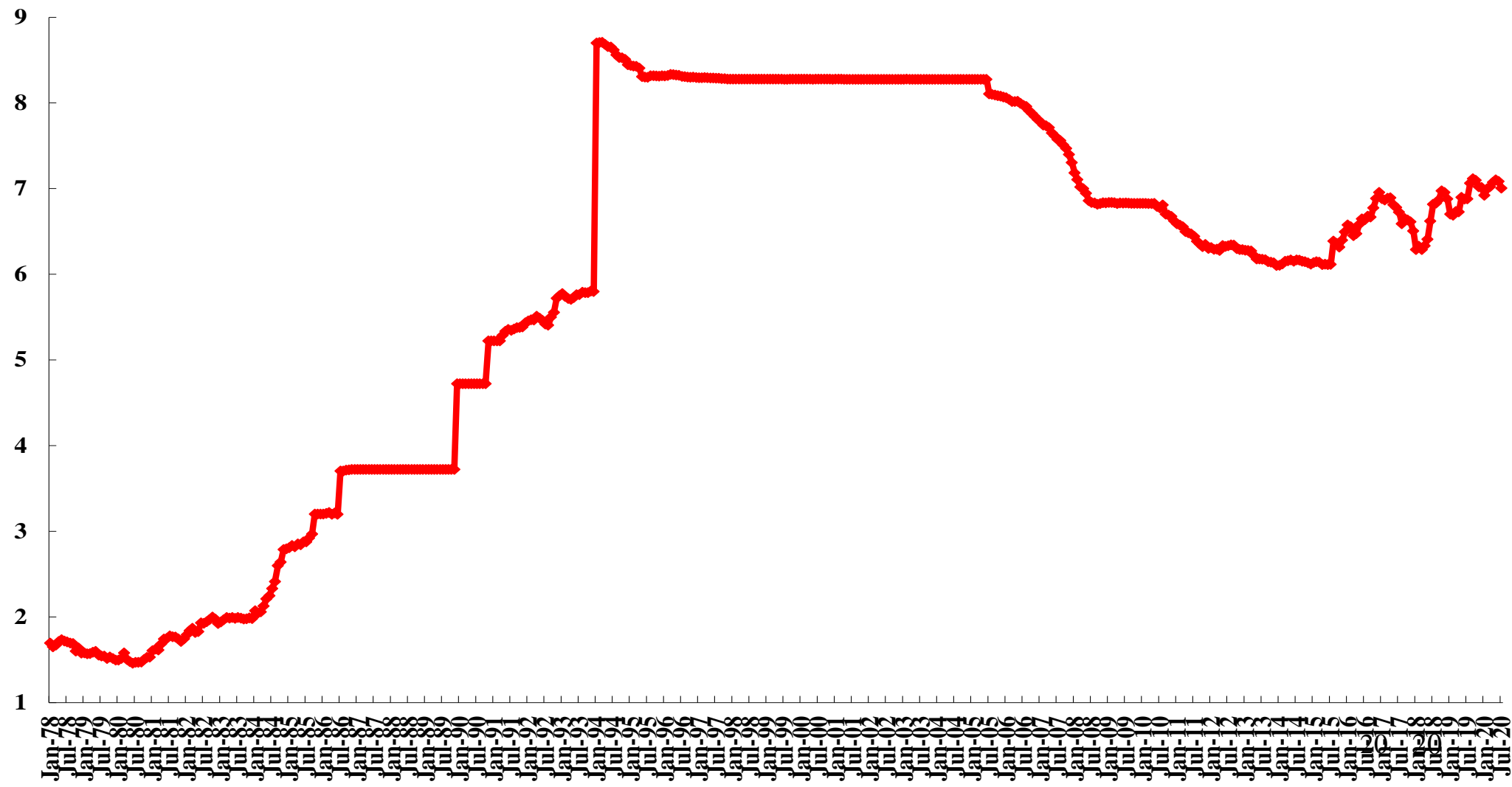
- ◆ On 15 November 2020, the Regional Comprehensive Economic Partnership (RCEP) Agreement was signed by 15 countries: the ten ASEAN countries, China, Japan, Korea, Australia and New Zealand. (India, which was originally included, decided to withdraw.) This is the largest free trade agreement ever, covering approximately 30% of the world's population, GDP and international trade. There is a proposal to reduce the rates of tariffs to zero among the members of RCEP.
- ◆ Negotiations are also underway among China, Japan and the Republic of Korea for a Free Trade Area.
- ◆ There is also the possibility of a Shanghai Cooperation Organisation (SCO) Free Trade Agreement, comprising China, India, Kazakhstan, Kyrgyzstan, Pakistan, Russia, Tajikistan, and Uzbekistan.
- ◆ The China-European Union Investment Agreement has been in negotiation for a long time. It will hopefully materialise soon.
- ◆ Going forward, China should pursue the “Four Zeroes” strategy—zero tariffs, zero non-tariff barriers, zero subsidies and zero export restrictions--with like-minded countries on a reciprocal basis, with “infant industry” and “national security” exceptions.

Continuing Economic Reform and Opening: The Internationalisation of the Renminbi

- ◆ As part of the continuing economic globalisation, China will be trying to increase the use of its own currency, the Renminbi, in the invoicing, clearing and settlement of its international transactions.
- ◆ One U.S. Dollar was worth less than 2 Yuan in 1978. Beginning in the early 1980s, the Renminbi devalued almost continuously until 1 January 1994, when it became current-account convertible with an exchange rate of 8.7 Yuan per US\$. Since then, the Renminbi has appreciated in both nominal and real terms. It current trades at less than 7 Yuan per US\$. In real terms, it has appreciated by almost 50%₁₉

Nominal Exchange Rate of the Renminbi, Yuan/US\$, 1978-present

Nominal Exchange Rate of the Renminbi, Yuan/US\$, 1978-present



The Inherent Advantages of Clearing and Settlement in Own Currencies

- ◆ The U. S. Dollar is the predominant international medium of exchange today-- approximately 40% of all international transactions is settled in U.S. Dollars, even though the U.S. accounts for only 11.3% of all international trade (including trade in both goods and services). This gives rise to seigneurage for the U.S.
- ◆ However, there are inherent advantages for two trading-partner countries to invoice, clear and settle their bilateral trade transactions in their own currencies:
- ◆ (1) Only a single currency exchange is involved, thus reducing transaction costs. (If a third-country currency is used, there will be two currency exchanges, for example, from one local currency into US\$, and then from US\$ into the other local currency.)
- ◆ (2) Since there is a time lag between the placement of an order and the actual delivery and payment, there will also be two exchange rate risks that have to be separately assumed by the respective exporter and importer if a third-country currency is used instead of one of the two own currencies.
- ◆ (3) Using own currencies for clearing and settlement reduces the need for official foreign exchange reserves that have to be maintained by the respective central banks.

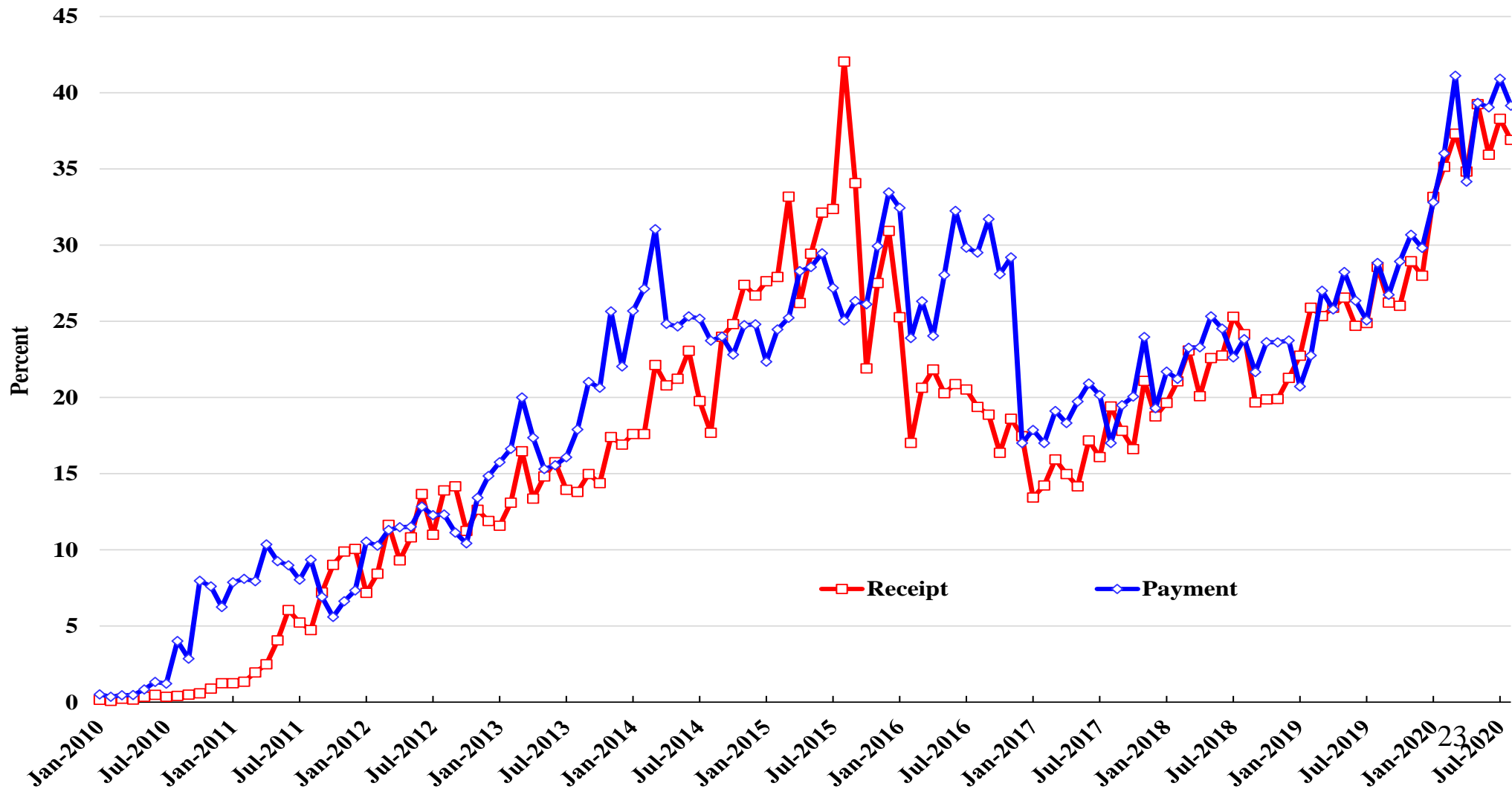
The Internationalisation of the Renminbi:

The Interbank Clearing and Settlement System

- ◆ China does not aspire to replacing the U. S. Dollar as the dominant international medium of exchange, but only wishes to protect itself and avoid the risk of being arbitrarily denied the use of the international system of clearing and settlement--**the Society for Worldwide Interbank Financial Telecommunication (SWIFT)** system--which the U.S. has periodically tried to use as an instrument of its unilateral sanctions, for example, against Iraq and Russia.
- ◆ The People's Bank of China has developed the **Cross-Border Interbank Payment System (CIPS)**, launched in 2015, for the clearing and settlement of cross-border RMB payments, operating independently of the SWIFT system. Foreign banks are welcome to participate in the CIPS system. In principle, the CIPS system can also be used to process payments in currencies other than the Renminbi among its members.
- ◆ Recently, a consortium of European countries have also established the INSTEX system so that they could conduct humanitarian trade with Iran without using the SWIFT system.

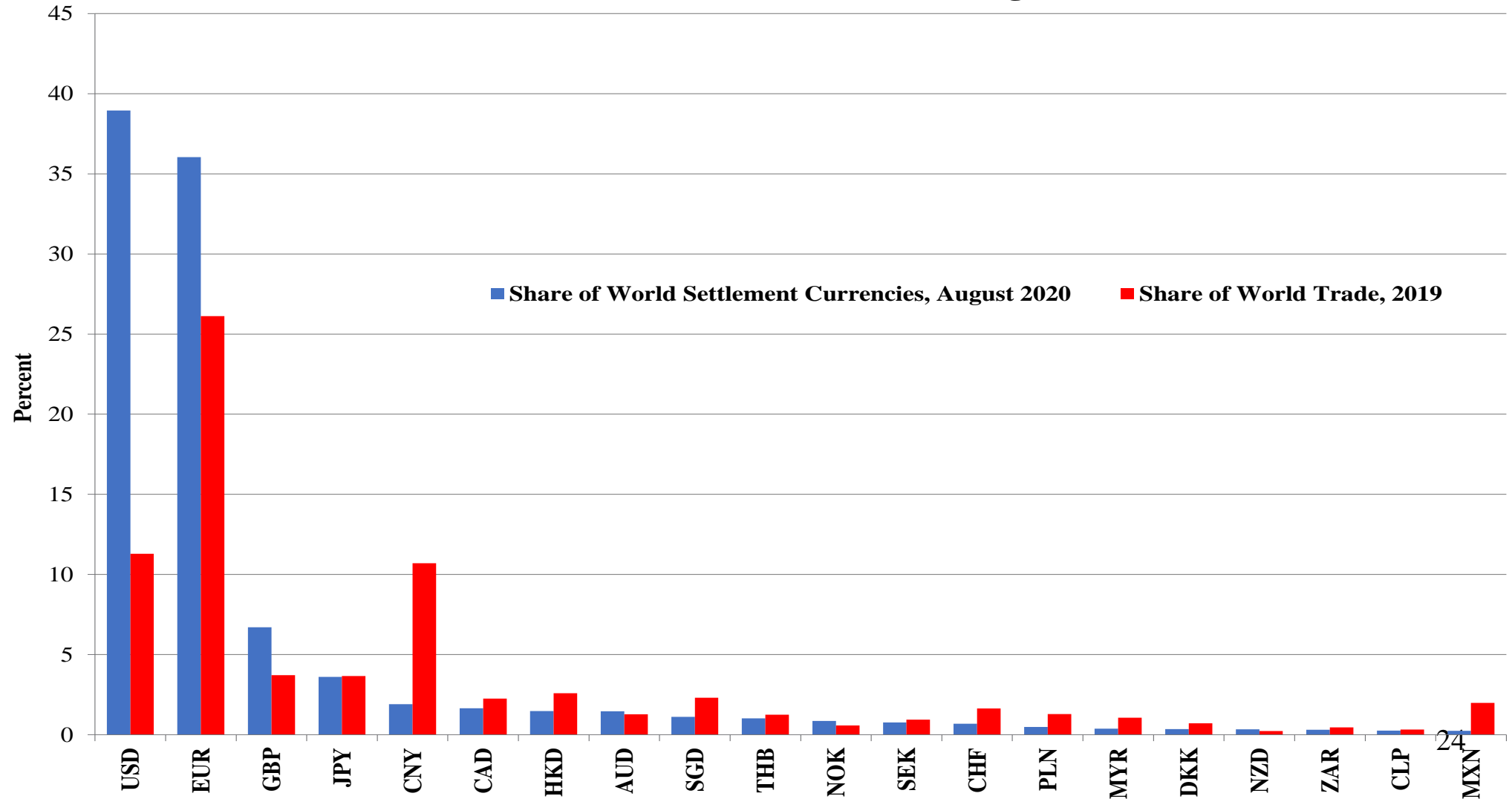
Share of Renminbi Settlement in China's Foreign Related Transactions

Share of Renminbi Settlement in China's Foreign Related Transactions



Share of World Settlement Currencies, August 2020

Share of World Settlement Currencies, August 2020



The Digital Currency for Electronic Payment (DCEP) of the People's Bank of China

- ◆ Digital payment platforms, such as Alipay or WeChat Pay, which work off a mobile telephone, can enable real-time settlement and automated currency exchange. They are thus a vast improvement over credit cards and debit cards. (These digital payment platforms are sometimes also referred as “digital currencies”, but they are strictly speaking not “digital currencies”. They only enable payment in the regular currencies by digital means.) These digital payment platforms will potentially replace the use of cash and also allow an economy to leap-frog completely the personal-checking-account phase.
- ◆ These digital payment platforms can also be used to facilitate the parallel circulation of two or more currencies in the same area. For example, there are many border areas between two or more countries or currency areas in which more than one currencies may circulate in parallel (between Canada and the U.S., and between China, Korea and Russia). Potentially the Guangdong-Hong Kong-Macau Greater Bay Area is also a place where three currencies, the Hong Kong Dollar, the Macau Pataca and the Renminbi, may circulate in parallel.

The Digital Currency for Electronic Payment (DCEP) of the People's Bank of China

- ◆ The “Digital Currency for Electronic Payment (DCEP)”, developed by the People's Bank of China (PBoC) is a true digital currency but not a crypto-currency. It always has the same identical value as the regular currency issued by the PBoC and is under its centralised control and management. Moreover, its ownership records are transparent to the commercial banks involved and the PBoC. It has a real-name requirement for the owner/user and uses a block-chain as a ledger record.
- ◆ Unlike the digital payment platforms, the PBoC digital currency does not charge any fees to its users (neither the payer nor the payee). In this sense it works just like regular paper currency. Moreover, it is completely open to any potential user and non-discriminatory (but on a real-name basis). Furthermore, it does not require the internet for transactions.
- ◆ It is likely to supplant Alipay and WeChat Pay or at least reduce their monopoly power eventually.
- ◆ Finally, the data on the users of DCEP will be kept confidential by the PBoC and will not be used for profit-making purposes, unlike the current electronic payment platforms. DCEP will definitely reduce the monopolistic power and the potential profitability of the commercial electronic payment platforms.

The Digital Currency for Electronic Payment (DCEP) of the People's Bank of China

- ◆ There is one additional feature of the DCEP that will come in handy for the PBoC, and that is, in the enforcement of capital control and in the detection and prevention of financial crimes.
- ◆ The block-chain distributed ledger for the DCEP means that each payment (receipt) can potentially be traced back to its ultimate origin, no matter how many times it has changed hands or has been sub-divided or combined until it is fully converted into physical cash.
- ◆ The block-chain feature enables the enforcement of capital control, if any, and facilitates the tracing of money laundering and terrorist financing as well as other criminal activities such as bribery, drug dealing, extortion and tax evasion.

The Future of Cryptocurrencies

- ◆ It is most unlikely that any sovereign government, China, the U.S., the U.K., you name it, will tolerate the existence of a cryptocurrency within its borders because it will lead to one or more of the following potential consequences:
 - ◆ (1) Loss of seigniorage by the central bank;
 - ◆ (2) Loss of control of monetary policy;
 - ◆ (3) Loss of tax revenue; and
 - ◆ (4) Loss of capital controlin addition to various types of crimes..
- ◆ Private cryptocurrencies will be outlawed for the same reasons that private commercial banks are forbidden to issue their own bank notes freely and that large-denomination notes have been withdrawn from circulation by many governments, including the U.S., as a way of fighting crimes.

Assisting Other Countries in Controlling the COVID-19 Pandemic

- ◆ China can assist other countries in controlling the COVID-19 pandemic, drawing from its own successful experience. Blockade and lockdown; rapid, and if necessary, mandatory testing; thorough contact tracing; maintaining personal hygiene; and social-distancing.
- ◆ China has a couple of COVID-19 vaccines in late-stage development. They include the Sinopharm, or China National Pharmaceuticals Group, vaccine and the Sinovac vaccine. China is committed to making the vaccine available through COVAX, a World Health Organization initiative. It is also ready to provide the vaccines to low-income countries at cost or even for free. China has committed to donate 2 billion doses of the COVID-19 vaccine to countries which cannot afford to pay.

The Role of China in the Prevention of Further Climate Change

- ◆ China will fulfill or exceed its commitments under the 2015 Paris Agreement; in particular, its carbon emissions will peak by 2030. In addition, President Xi Jinping of the People's Republic of China has also pledged that China will become carbon-neutral by 2060. This bold commitment from the currently largest carbon emitting country in the world provides the basis for everyone to work together.
- ◆ More recently, following President Xi's announcement, Prime Minister Yoshihide Suga of Japan has also announced that Japan will become carbon-neutral by 2050, the same date as an earlier commitment by the European Union.
- ◆ All of this will have huge implications on the development of the entire world economy, including both the Chinese and Japanese economies, during the next several decades, as major structural shifts occur in fixed investments in basic infrastructure and in both supply and demand of goods and services.
- ◆ If this “carbon-neutrality” project of China turns out to be successful, it can show the way for other developing countries to achieve carbon-neutrality.

Concluding Remarks

- ◆ The cashless digital payment platforms being launched around the world as well as the Digital Currency for Electronic Payment (DCEP) of the PBoC will lead to the demise of personal checking accounts in almost all countries, just like the mobile telephones replacing the fixed landline telephones. They will also supplant the use of cash.
- ◆ There will be greater use of own currencies for clearing and settlement of cross-border transactions. One implication of the greater use of own currencies is the growth of direct bilateral currency markets.
- ◆ With China's continuing participation in the world economy, and given its high rate of growth, China will eventually become not only the largest economy in the world, but also the largest trading nation in the world. The total volume of both Chinese and global international transactions should and will increase further in the future.

Concluding Remarks

- ◆ While the introduction of the Chinese centralised digital currency per se is not expected to affect the acceptance of the Renminbi in the clearing and settlement of international transactions significantly, it will facilitate the gradual relaxation of the remaining control of capital into and out of parts of the Mainland and eventually Mainland as a whole.
- ◆ The governance of the world financial institutions such as the International Monetary Fund and the World Bank will gradually undergo changes, reflecting the changed composition of the global economy.
- ◆ There will also be more regional groupings of countries to enable and facilitate collective own-currency clearing and settlement, using the experience of the Bank for International Settlements in the 1950s as a template, and if necessary coordinated real exchange-rate adjustments.
- ◆ However, given the China-U.S. strategic competition, which is expected to be the new normal in the next decade or so, there may well emerge parallel but inter-operable systems for the clearing and settlement of international financial transactions and 5G telecommunication. The resulting competition and redundancy may actually protect and stabilise the world economy from potential monopolistic practices, catastrophic failures and arbitrary unilateral actions, and perhaps even improve the quality of the services.