

DEAN'S DISTINGUISHED SPEAKER SERIES



Dean's Distinguished Speaker Series

Navigating US-China Financial Decoupling

📅 19 September 2024, Thursday 🕒 6.30 pm - 9 pm 📍 Hybrid Event

MODERATOR



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SPEAKER



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US-CHINA: POTENTIAL FINANCIAL DECOUPLING

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09/19/2024



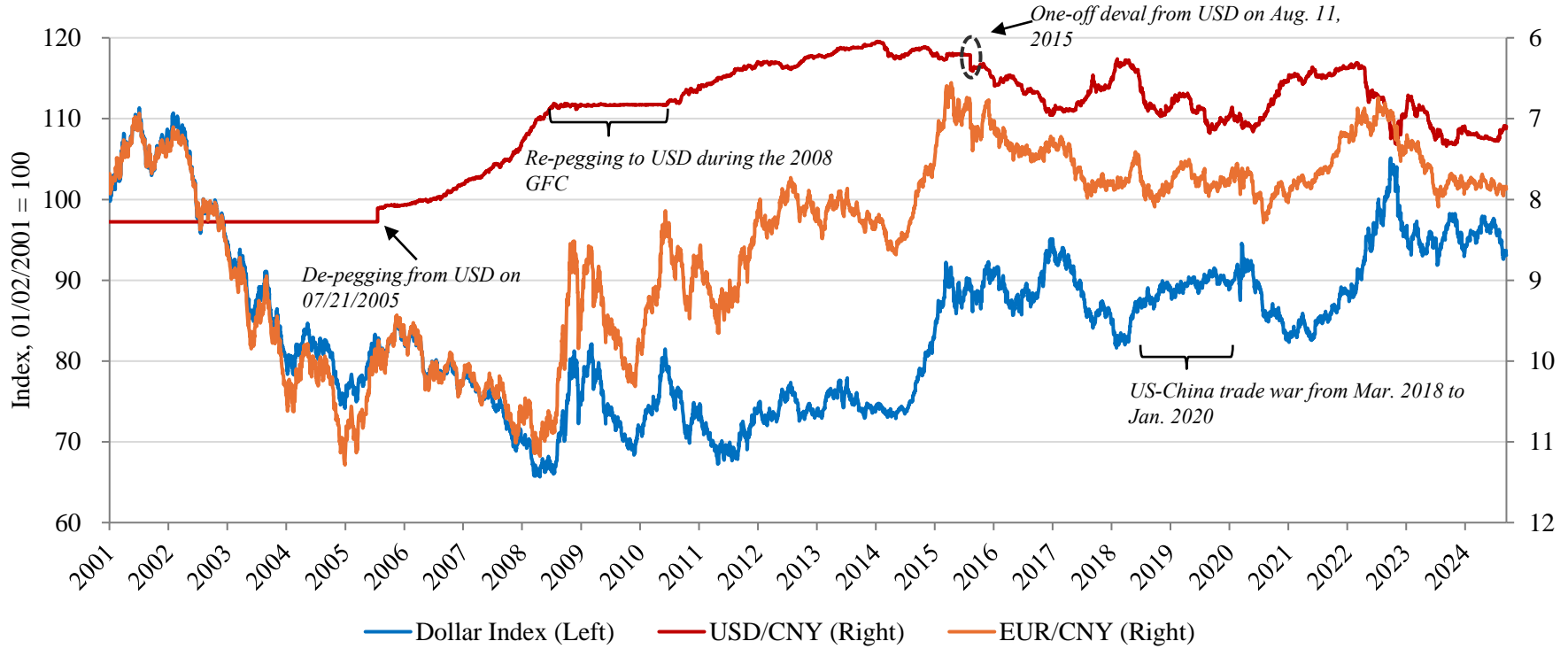
TWO TIERS OF US-CHINA FINANCIAL DECOUPLING

- ❖ DECOUPLING OF US-CHINA CURRENCY REGIMES
(MACRO-DECOUPLING):
 - ❖ RMB is increasingly more independent from US Dollar,
 - ❖ Chinese policymakers are pursuing the internationalization of RMB as a global reserve currency
 - ❖ A case study of sanctions on Russia

- ❖ DECOUPLING OF US-CHINA CAPITAL MARKETS
(MICRO-DECOUPLING):
 - ❖ Some US policymakers and lawmakers are pushing for diminishing financial ties between capital markets of US and China; “national security”



ISSUE I: WILL US AND CHINA GET INTO A NEW CURRENCY WAR (1)



Source: Wind



ISSUE I: WILL US AND CHINA GET INTO A NEW CURRENCY WAR (2)

❖ US Policy Action

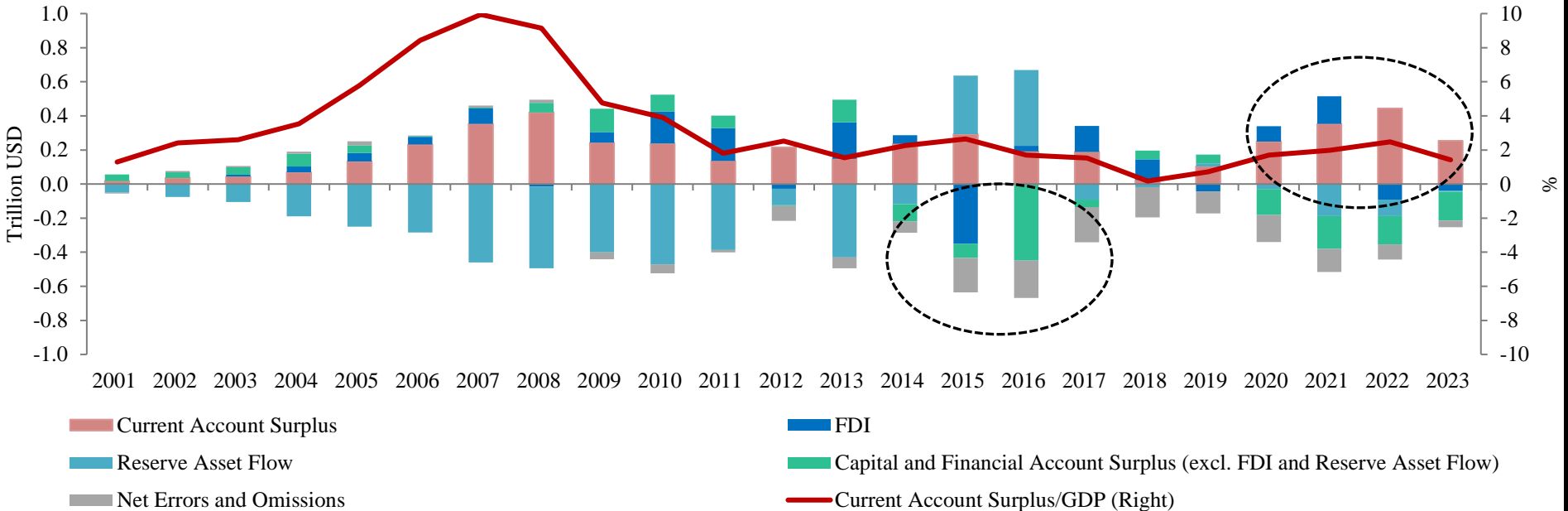
- ❖ In August 2019, the US Treasury Department labeled China as a “**currency manipulator**” for the first time since 1994, after PBC allowed the RMB to weaken past the psychologically important threshold of 7
 - *“China has a long history of facilitating an undervalued currency through protracted, large-scale intervention in the foreign exchange market. In recent days, China has taken concrete steps to devalue its currency, **while maintaining substantial foreign exchange reserves despite active use of such tools in the past**”*
- ❖ The Trump administration was concerned that China might deliberately use an undervalued currency to make its export more competitive and offset the effects of US tariffs. But this step was only symbolic, as the most severe sanction measure—high tariff— had already been used during the US-China trade war
- ❖ In January 2020, the tag was lifted as part of the US-China Phase One trade deal, in which China is committed to achieving and maintaining a market-determined exchange rate regime



ISSUE I: WILL US AND CHINA GET INTO A NEW CURRENCY WAR (3)

Fundamentally, RMB is unlikely to depreciate dramatically against USD, due to the robust current account surplus by China

China's Annual Balance of Payment



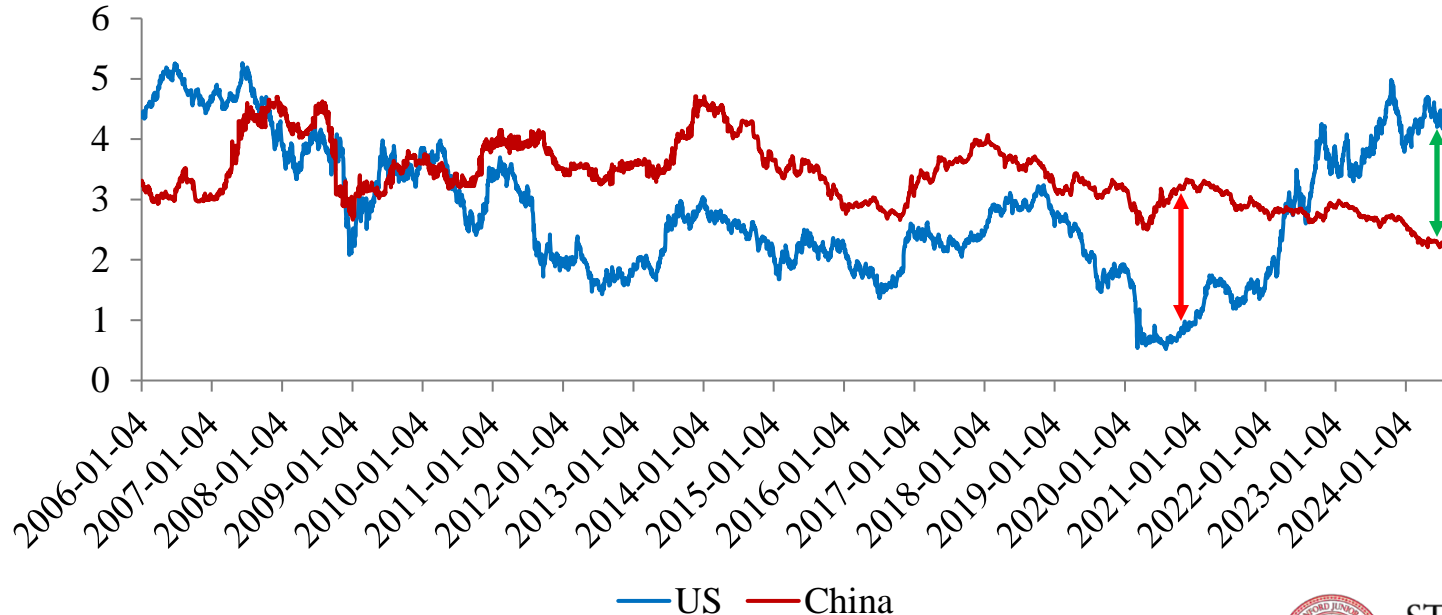
Source: SAFE



ISSUE I: WILL US AND CHINA GET INTO A NEW CURRENCY WAR (4)

However, the interest rate spread between Chinese and US Treasuries has inverted and widened significantly in recent years

US-China 10Y Treasury Yield Spread



Source: CEIC and FRED



ISSUE II: WILL RMB CHALLENGE USD AS A RESERVE CURRENCY (1)

“2% Reserve Currency ” --- RMB’s share in global monetary system

Rank	Shares in global payment system (as of 07/2024)	Shares in global trade finance market (as of 08/2024)	Shares in global FX reserves (as of 2024Q1)	Share in the SDR basket (2022-2027)
1	USD: 47.81%	USD: 83.22%	USD: 58.85%	USD: 43.38%
2	EUR: 22.47%	CNY: 6.00%↑ <i>(2020: 2.05%)</i>	EUR: 19.69%	EUR: 29.31%
3	GBP: 7.00%	EUR: 5.83%	JPY: 5.69%	CNY: 12.28% <i>(2020: 10.92%)</i>
4	CNY: 4.74%↑ <i>(2020: 1.88%)</i>	JPY: 1.46%	GBP: 4.89%	JPY: 7.59%
5	JPY: 3.62%	SAR: 0.82%	CNY: 2.15% <i>(2020: 2.13%)</i>	GBP: 7.44%

Source: SWIFT RMB Tracker, IMF’s COFER Database



ISSUE II: WILL RMB CHALLENGE USD AS A RESERVE CURRENCY (2)

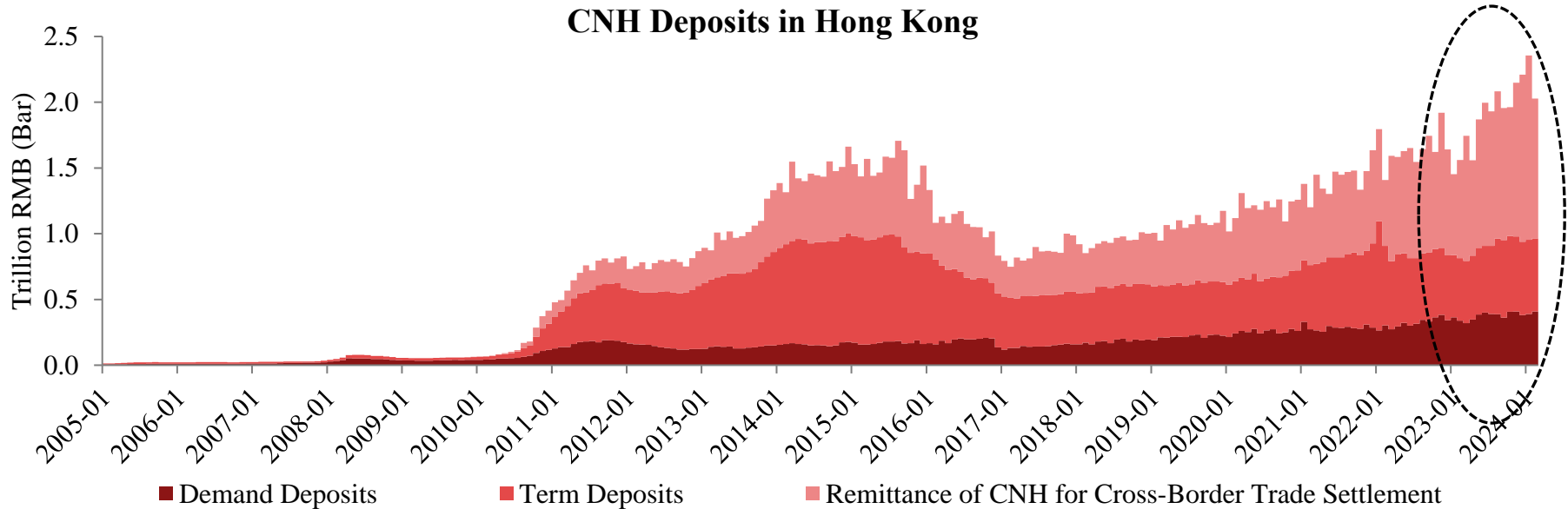
- ❖ THE ELEPHANT IN THE ROOM: CAPITAL ACCOUNT LIBERALIZATION
 - ❖ It has been significantly slower than expected
 - ❖ **Historical lessons:** Chinese policymakers are mindful of lessons from the 1997-1998 Asian Financial Crisis and China's own setback of currency/capital account reform in August 2015
 - ❖ **Timing is everything.** In the midst of big interest rate differential (below US) and slowing domestic economy?
 - ❖ **Balance between domestic reform and external reform:** The PBC has been a lonely warrior of reforms, because China's capital markets and financial institutions were not ready for capital account reform in the past few years



ISSUE II: WILL RMB CHALLENGE USD AS A RESERVE CURRENCY (3)

❖ China's efforts for internationalization of the RMB

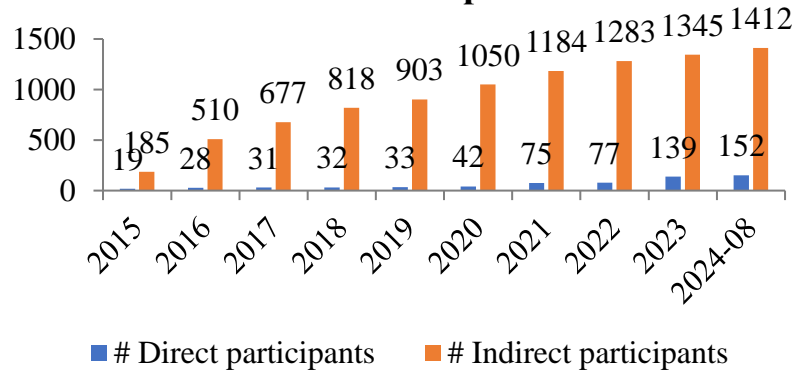
- HK offshore RMB market



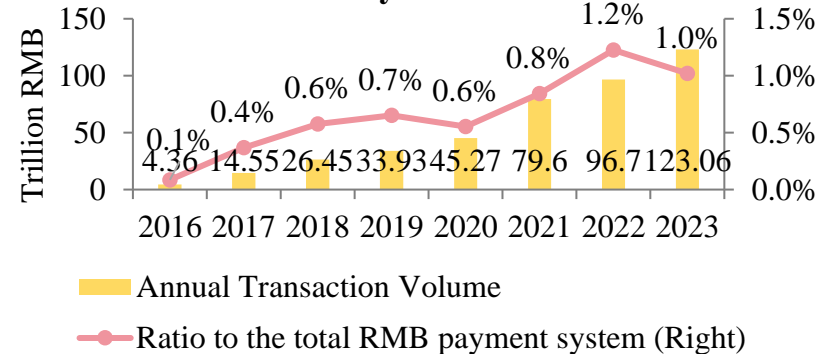
ISSUE II: WILL RMB CHALLENGE USD AS A RESERVE CURRENCY (4)

❖ The Cross-Border Interbank Payment System (CIPS)

CIPS Participants



CIPS Payment Volumes



- ✓ As of August 2024, among indirect participants, there were 1050 in Asia, 243 in Europe, 52 in Africa, 26 in North America, 20 in South America, and 21 in Australia
- ✓ CIPS is not China's carbon copy of SWIFT. It is a Chinese payment system for cross-border RMB payments and trade clearing and settlement
 - In terms of messaging service, direct participants can use SWIFT or CIPS's own messaging, but indirect participants send and receive instructions through SWIFT
 - As of 2022, estimates indicated that 80% of payments through CIPS use SWIFT messaging



ISSUE III: THE CASE OF RUSSIA (1)

❖ US SANCTIONS ON RUSSIAN FINANCIAL SYSTEM

- ❖ Major sanctions were imposed following Russia's invasion of Ukraine in February 2022, with additional measures taken thereafter
- ❖ A key aspect of the US sanctions program against Russia has been isolating Russia's financial system from the US dollar economy
- ❖ Primary Types of Sanctions
 - Banking system
 - Central bank



ISSUE III: THE CASE OF RUSSIA (2)

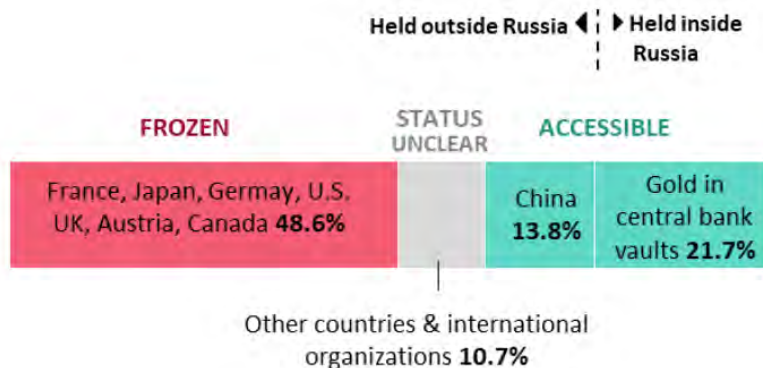
❖ **Banking System: 80% of Russian banking sector assets are affected by the sanction**

- **Full blocking sanctions:** All assets under U.S. jurisdiction were immediately frozen. U.S. individuals and entities are prohibited from conducting any business with these targeted companies
 - Russia's two largest banks (Sberbank and VTB), defense sector-connected (VEB and PSB), and other systemically-important financial institutions
- **Debt and equity restrictions:** Prohibit all transactions in, provision of financing for, and other dealings in new debt or new equity issued
- **SWIFT removal:** 02/26/2022, several Russian banks were removed from SWIFT. Later 05/31/2022, Sberbank.
 - Unlike several other major Russian banks, Gazprombank has not been removed from SWIFT. This exception is primarily due to its crucial role in facilitating payments for Russian energy exports, particularly natural gas



ISSUE III: THE CASE OF RUSSIA (3)

❖ FX Reserves. Frozen those outside Russia



Source: Bank of Russia, June 2021

❖ Gold

- Limit the usability of the Russian central bank's gold, by establishing sanctions on foreign persons who participate in significant transactions with **Russian gold**

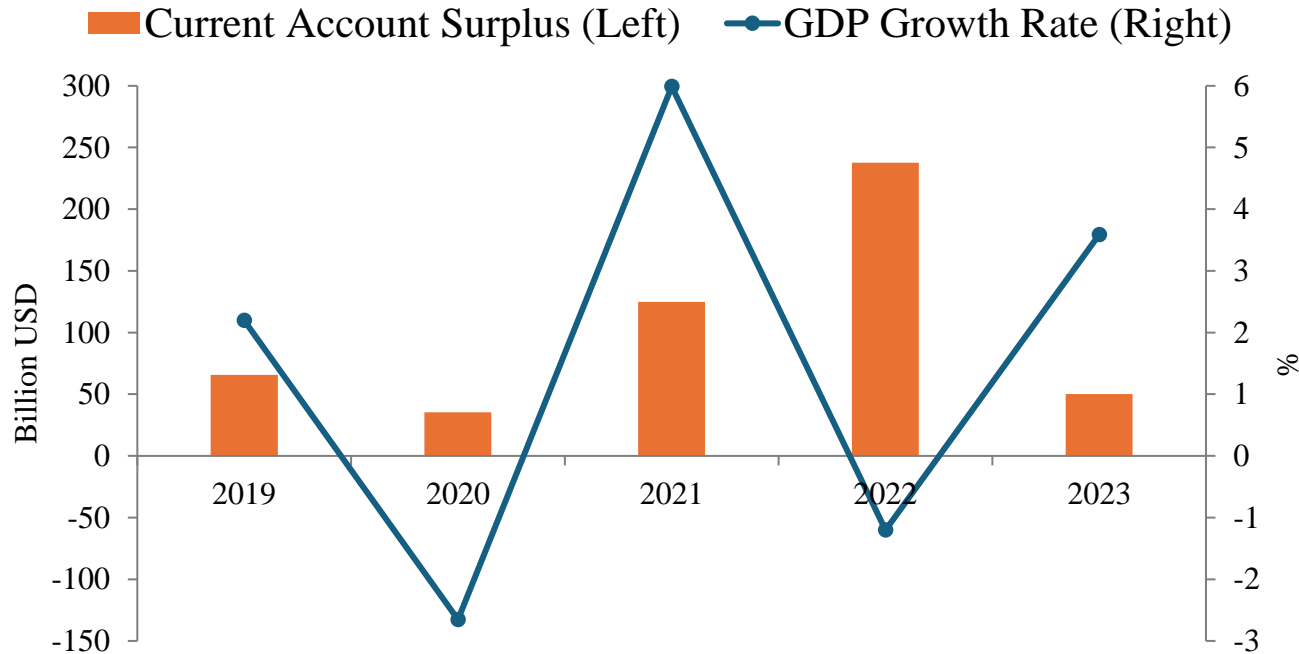
❖ SDR

- Prohibit US transactions with Russia involving IMF reserve assets, **SDR**



ISSUE III: THE CASE OF RUSSIA (4)

❖ IMPACTS OF THE SANCTIONS



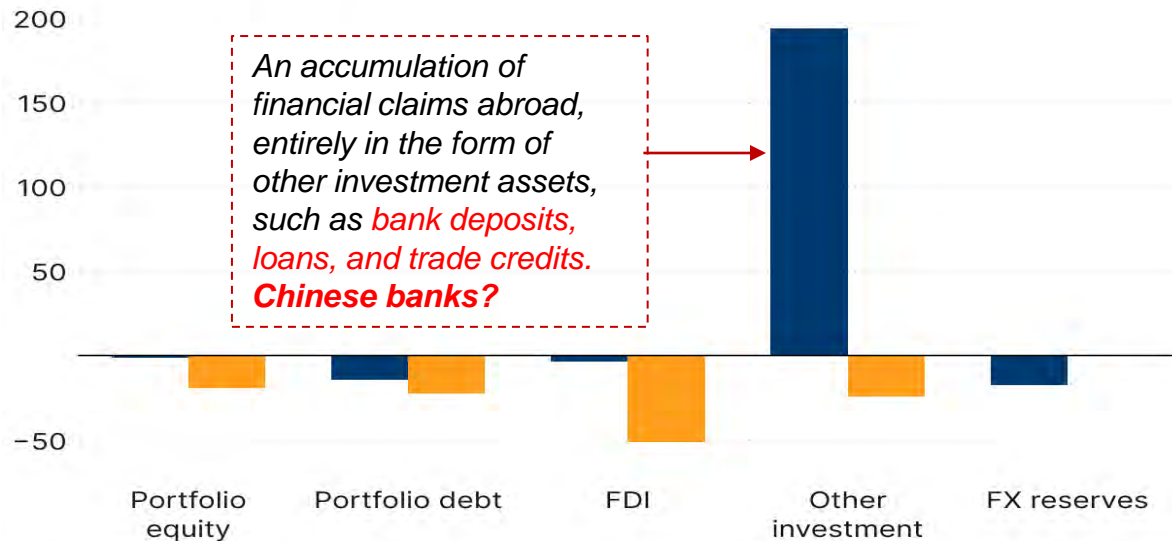
ISSUE III: THE CASE OF RUSSIA (5)

❖ WHERE HAVE THE CURRENT ACCOUNT SURPLUSES GONE?

Russia: Net accumulation of external assets and liabilities 2021-23

Billions of USD

■ Assets ■ Liabilities



Source: Central Bank of Russia, External Wealth of Nations, and Authors' Calculations



ISSUE III: THE CASE OF RUSSIA (6)

❖ THEN, HOW ABOUT CHINESE BANKS?

- ❖ On Dec 22, 2023, President Biden issued an Executive Order (E.O. 14114), granting new authority to impose sanctions on foreign financial institutions that facilitate significant transactions involving Russia's military-industrial base, **even where there is no U.S. nexus to the transaction**. This action marks the U.S. government's first use of **“secondary sanctions”** under the recent Russia sanctions program
- ❖ On June 12, The Office of Foreign Assets Control broadened the definition of “Russia's military industrial base” in EO 14114 to include all persons subject to blocking sanctions under EO 14024, expanding beyond the previously specified sectors



ISSUE III: THE CASE OF RUSSIA (7)

❖ **Highly unlikely that US would remove Chinese banks out of SWIFT. Why?**

- Chinese banks are much bigger and more important. The Big 5 are in the list of 30 global systemically important banks (G-SIBs) by Financial Stability Board (FSB)
 - ✓ On Nov 9, 2023, a ransomware attack on ICBC disrupted U.S. Treasury trades. Yields on Treasury bonds rose sharply on Nov 9 afternoon, after a particularly poor auction for 30-year bonds. The 30-year yield rose by 12 bps
- February 2020, a joint venture between PBC and SWIFT to use its infrastructure to promote the international use of RMB
- Economic interdependence: deep economic ties between China and the world make broad sanctions potentially harmful to the global economy



MICRO: KEY FACTS OF US-CHINA FINANCIAL INTEGRATION

- ❖ As of January 8, 2024, 265 Chinese companies listed in US stock exchanges, with a total market capitalization of \$0.85 tn;
- ❖ As of April 2024, China held \$0.77 tn in U.S. Treasury securities, second largest holder following Japan;
- ❖ It was estimated that Chinese holdings of US corporate stocks and bonds were about \$0.33 tn as of June 30, 2023;
- ❖ US cross-border lending to Chinese firms (loans & debt securities) was approximately \$0.39 tn as of the end of 2023;
- ❖ As of the end of 2022, US holdings of equity securities in mainland China and HK were approximately \$0.35 tn

While it still ranks among the trillion-dollar businesses that cannot be ignored, there has been a dramatic decrease from approximately \$5 trillion in 2021 to about \$2.7 trillion today



ISSUE I: DELISTING CONCERN (1)

❖ US Policy Action: Holding Foreign Companies Accountable Act

- ❖ 08/26/2022, PCAOB signed a Statement of Protocol Agreement with the CSRC and MOF regarding cooperation in the oversight of PCAOB-registered public accounting firms

US Version

1. The PCAOB has **sole discretion to select** the firms, audit engagements and potential violations it inspects and investigates – without consultation with, nor input from, Chinese authorities.
2. Procedures are in place for PCAOB inspectors and investigators to view **complete audit work papers** with all information included and for the PCAOB to retain information as needed.
3. The PCAOB has **direct access to interview and take testimony** from all personnel associated with the audits the PCAOB inspects or investigates.

China Version

1. 双方将提前就检查和调查活动计划进行沟通协调 (The two sides will **communicate and coordinate in advance** to plan for inspections and investigations.)
2. 美方须查看的审计工作底稿等文件通过中方监管机构协助调取并提供 (The materials such as audit work papers that the U.S. regulator need access to will be **obtained by and transferred through the Chinese side.**)
3. 美方在中方参与和协助下对会计师事务所相关人员展开访谈和问询 (The Chinese side will **also take part in and assist in the interviews and testimonies** of relevant personnel of audit firms requested by the U.S. side.)

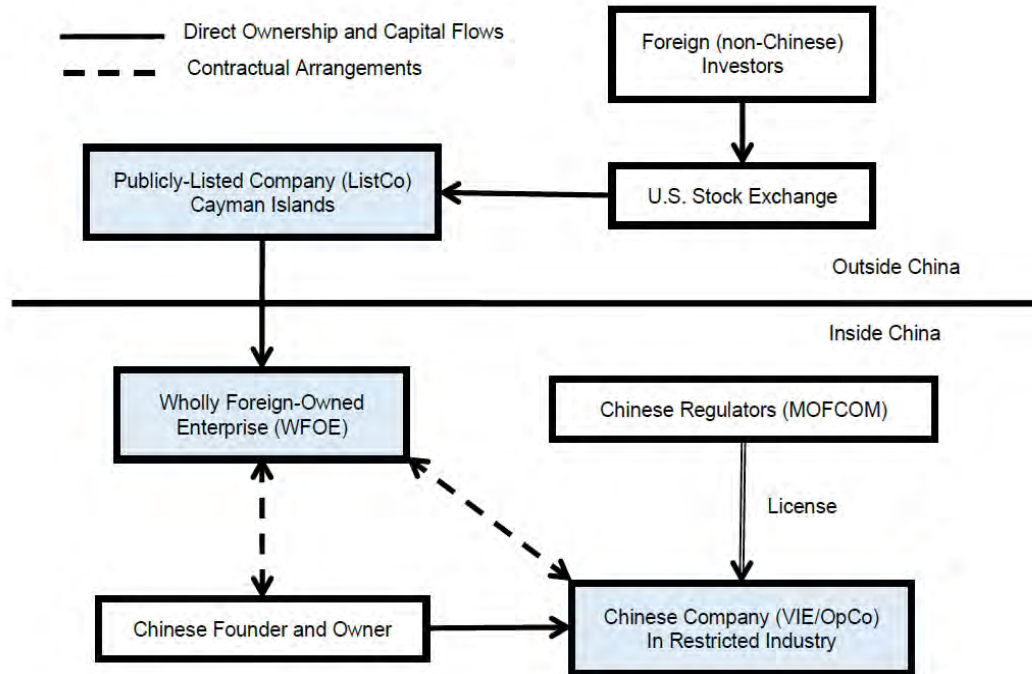
- PCAOB inspectors started the onsite audit inspections in HK since Sep 2022; China sent regulators to HK to assist U.S. audit inspection



ISSUE I: DELISTING CONCERN (2)

❖ US Policy Action: HFCAA (cont.)

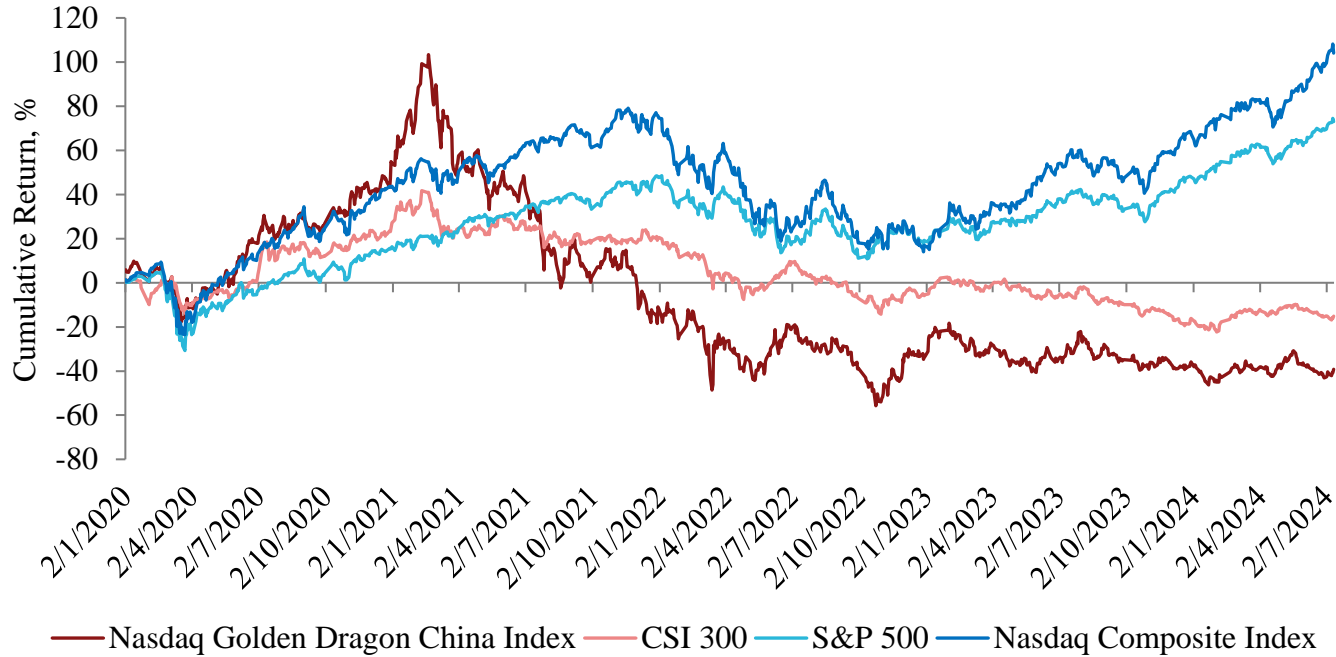
- ❖ In July 2021, the SEC issued an alert to investors warning about potential risks in investing in U.S.-listed companies that have contracts with but no control over operating entities in China (**VIE structure**)



ISSUE I: DELISTING CONCERN (3)

❖ Chinese firms listed in the US

- ❖ As of Jan 8, 2024: 265 firms, \$0.85 trillion market cap
 - No SOEs listed
 - In comparison: 248 firms, \$2.1 trillion market cap, as of May 5th, 2021



Source: Wind



ISSUE II: DIVESTING ISSUE (1)

- ❖ US Policy Action: President Trump issued *E.O. 13959* in Nov 2020 barring investing in a list of companies with ties to **the Chinese military**
 - ❖ Prohibits American companies and individuals from owning shares (outright or through investment funds) in companies the administration says are backed by the People's Liberation Army
 - ❖ 31 Chinese companies on the list, including *Huawei (华为)*, *China Mobile (中国移动)*, *China Unicom (中国联通)*, and *China Telecom (中国电信)*, *China National Offshore Oil Corporation (CNOOC, 中海油)* etc.
 - ❖ **NYSE delisted *China Mobile, China Unicom, China Telecom, CNOOC*, to comply with *E.O. 13959* in May 2021**



ISSUE II: DIVESTING ISSUE (2)

❖ **US Policy Action: CFIUS and Local Intervention**

- ❖ The Committee on Foreign Investment in the US (CFIUS) serves the President in overseeing the national security risks of certain FDI in the US economy
- ❖ When the CFIUS does not have authority to block a transaction, local governments are starting to fill the gaps
- ❖ Fufeng USA, U.S. subsidiary of Chinese food manufacturer 阜丰
 - Fufeng USA bought 300 acres in North Dakota in 2022, planning a corn mill 12 miles away from Grand Forks Air Force Base, sparking national security concerns
 - Fufeng USA announced CFIUS lacked jurisdiction over their land acquisition
 - ✓ CFIUS reviews deals within 1 mile of sensitive bases and 99 miles of highly sensitive ones. Grand Forks Air Force Base is classified as sensitive, so the 12-mile distance of Fufeng's land fell outside CFIUS's jurisdiction
 - Since CFIUS could not act, local communities took matters into their own hands. On 02/06/2023, the Grand Forks City Council voted to block this project. **While unable to force land sale, the council can deny building permits and infrastructure access, effectively halting the project**



FINANCIAL DECOUPLING?

❖ Huge interest at stake

- ❖ As we analyzed above, the US-China financial integration represents a trillion-level business

❖ But, US-China relationship is deteriorating and could be even worse

- ❖ US-China relationship **“will be competitive when it should be, collaborative when it can be, and adversarial when it must be”**
- ❖ Small yard, high fence 小院高墙

❖ The movement of global investors reflect market forces

- ❖ The Fed will likely refrain from hiking interest rate before the end of 2024. So will the ECB and the BoJ
- ❖ Beijing solicits interest from patient capital (耐心资本)
- ❖ At the end of the day, market forces speak for themselves
- ❖ **The recent and severely lagged retreat from US/Europe funds reflects increasingly pessimism on China’s economy**

