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"China's Quest for Capital: Motivations, Methods, and Implications"

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More Important than Financial Gain:

Protecting the Rule of Law and Advanced Technology

by Derek Scissors

The starting point of assessing Sino-American financial ties is that Beijing has wasted a huge amount of money in the past decade and seeks foreign capital to meet still-ambitious development goals. US portfolio and, especially, direct investment flows to China are not especially large but Chinese need and American corporate interest could cause them to jump.

This could benefit the US, but only if multiple important changes are made quickly. In particular, the rule of law must in all ways prevail over financial interest and present and future American technology restrictions should include restricting investment that could support Chinese development in targeted sectors. Combining those: Chinese entities involved in advanced technology which have broken the law should be entirely cut off from US capital.

China Needs Money

The Communist Party seeks to minimize foreign influence over the People's Republic of China (PRC). It follows that the Party does not allow American influence in the economy unless it needs something. For a full generation, it needed to generate employment and did so in part by selling to American consumers. With the Chinese labor force set to shrink for a least a generation,[1] employment is less of a concern. In the second half of the reform era, of course, the PRC has also chased American technology, legally and illegally.

And Beijing at all times has wanted American (and other foreign) money. This was obvious in the early years, when the PRC's foreign exchange reserves were inadequate to pay for desired imports. Casual observers see China as now wealthy enough to no longer care much about American capital or at least rich in foreign reserves. The former has never been true and the latter is no longer true.

The minor one: the PRC's total foreign exchange in the banking system fell over $1.2 trillion from 2014 through 2016, then stopped being regularly reported. Official reserves – a subset of total foreign exchange -- peaked in mid-2014 and fell $900 billion from there until the end of 2019.[2] While still huge at $3.1 trillion, reserves finance annual imports of about $2 trillion as well as China's global spending in hard currency, such as on the Belt and Road Initiative. Beijing does not yet need a foreign exchange boost; it does now need foreign exchange stability.

The domestic financial situation is considerably worse. The economy is large but far from rich. There will be talk this year of China's GDP *per capita* hitting $10,000 but that is an accounting result, not money people can actually spend. Beijing's reports 2019 personal income *per capita* at $4400. The most comparable American figure is $50,000 larger. In mid-2019, Credit Suisse put China's average wealth per adult at less than one-seventh that of the US - $370,000 lower.[3] The ratio shrunk over the previous decade but the absolute size of the gap widened.

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[1] http://www.china.org.cn/china/2019-01/25/content_74408194.htm
[2] China Monthly Statistics, Volumes 277-301, National Bureau of Statistics, People's Republic of China and https://www.safe.gov.cn/en/2018/0517/1433.html
[3] http://www.stats.gov.cn/english/PressRelease/202001/t20200117_1723398.html https://fred.stlouisfed.org/series/A792RC0A052NBEA and https://www.credit-suisse.com/about-us/en/reports-research/global-wealth-report.html

That the PRC badly needs to keep growing should not be news. Prospects are mediocre and deteriorating. Beijing does not permit competition with state-owned enterprises in two dozen major sectors, unavoidably limiting innovation. The top reason for low wealth is the state owns all rural land, [4] robbing nearly 600 million people of their most valuable asset. As is well known, China is aging. Another 2020 event may be median Chinese age surpassing American. By 2045, the PRC is projected to be older than the US will be by the end of the century.[5]

This puts the burden of growth on the country's capital stock, a burden it has not met. There are constant, breathless reports about how much China is spending across many industries and even in other countries. It has not altered the (extremely) steady deceleration in official GDP growth over the past decade.[6] The reason for this: Beijing has wasted enormous sums of money, as shown in indicators compiled by the central government and independently.

Following international practice, China has published broad money M2 for decades. At the end of 2008, American M2 was almost $1 trillion larger than Chinese. At the end of 2019, it was almost $12 trillion smaller, despite American GDP still being about $7 trillion larger. There are frequent comments that the PRC faces liquidity squeezes in one place or another.[7] This is only sensible if huge amounts of money stock are basically dead.

A typical defense of the PRC's excessive money supply is its financial system differs from that of the US and EU and has diverged rather than converged, as some hoped. Independently organized data from the Bank of International Settlements show the situation is plainly worse than that.[8] At the end of 2008, China's outstanding credit as a percentage of GDP was 143 percent. America's was 240 percent and India's was 129 percent. In the middle of 2019 (latest), America's was 250 percent, India's was 124 percent, and China's was 262 percent.

India could stand a bit more credit growth and the US less. The explosion in Chinese credit is unmatched among major economies in the past 20 years. It began with corporate credit but since 2012 has latched onto government and households. Everyone has borrowed faster than GDP grew, even net of repayment. China still needs rapid growth but is aging and refuses key reforms. It has borrowed and spent but became worried about foreign exchange stability and, more so, domestic debt and in late 2017 turned to American and other external sources of capital.[9]

Sino-American Financial Relations

The PRC receives American capital in multiple channels. The largest is often overlooked. From 2010 through 2019, the US merchandise trade deficit with the PRC reached $3.4 trillion (services

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[4] https://www.aei.org/research-products/report/making-new-normal-meaningful/ and https://www.nytimes.com/2019/09/26/world/asia/china-land-rights-farming.html

[5] https://www.economist.com/finance-and-economics/2019/10/31/chinas-median-age-will-soon-overtake-americas and https://population.un.org/wpp/DataQuery/

[6] http://www.stats.gov.cn/tjsj/ndsj/2018/indexeh.htm

[7] https://fred.stlouisfed.org/tags/series?t=m2 and https://www.wsj.com/articles/chinese-regulators-try-to-calm-fears-of-a-funding-squeeze-11560770645

[8] https://www.bis.org/statistics/totcredit.htm?m=6%7C380%7C669

[9] https://www.ey.com/Publication/vwLUAssets/ey-china-further-opens-up-financial-sector/$FILE/ey-china-further-opens-up-financial-sector.pdf

were in surplus).[10] Until reserves fell in 2014, this was a luxury. From then, the goods surplus with the US has been necessary to avoid balance of payments instability the Party has feared since the Asian crisis. The magnitude of American payments is so large as to matter even to China's huge money stock. Without goods trade with the US, Chinese finance would involuntarily look very different.

Tariffs trimmed the 2019 bilateral merchandise imbalance to about $350 billion and either the Chinese purchases promised in the "phase 1" trade deal or, in their absence, more tariffs will likely cut into it further in 2020. But $300 billion in 2020 is about as much a drop as can be expected. The trade surplus with the US will be less important to Chinese finance this decade than the previous one, but it will still have sizable impact.

The conventional way American money heads to the PRC is through direct investment. The amounts here are not impressive. At the start of 2010, the US direct investment position in China and Hong Kong combined was $105 billion, by 2019 it was approximately $210 billion.[11] The doubling is not trivial but Singapore – among other things a route to Indonesia and Malaysia -- saw more growth and a higher total by 2019.

The stock of American direct investment abroad exceeds $6 trillion, so it is certainly possible investment in the PRC could soar. But there was no sign of this in 2019 and, with China's economy continuing to slow, the country may be turning into a sector play in health care and the environment, for instance, rather than a truly national draw. American direct investment may be vital to China technologically but it is not financially. (Note: sales of American affiliates in the PRC are much larger than direct investment but do not qualify as a source of capital.)

The core series for portfolio investment is Treasury's US holdings of foreign securities. American portfolio investment in China and Hong Kong is noticeable, but still a small fish in the portfolio flow sea.[12] At the start of 2010, it stood at $193 billion; in September 2019 (latest), it was $366 billion. This easily outweighs Singapore but is barely more than one-third of the total for Japan, much less Canada and western Europe.

The trend should be for more US investment, due to the market opening in late 2017. However, after a rush for the first few months then, interest has been restrained. American holdings are dominated by common stock and it remains the case that the PRC's stock market is deeply flawed, featuring dubious accounting.[13] American portfolio investment in India and Taiwan grew faster last decade – China matters to US portfolio investment, but not much.

Two facets of holding Chinese stock have received outsized attention. There will be an increase in passive investment by perhaps unwitting Americans due to global funds assigning the PRC higher weights.[14] That process has begun but its full weight will only be evident in 2020. There

[10] https://www.census.gov/foreign-trade/balance/c5700.html
[11] https://www.bea.gov/international/di1usdbal
[12] https://www.treasury.gov/resource-center/data-chart-center/tic/Pages/ticsec2.aspx and https://www.treasury.gov/resource-center/data-chart-center/tic/Pages/shcreports.aspx
[13] https://www.ft.com/content/6ae569ee-b336-11e9-8cb2-799a3a8cf37b
[14] https://www.msci.com/documents/10199/238444/China_A_Further_Weight_Increase_PR_Eng.pdf/43f3ee8b-5182-68d4-a758-2968b4206e54

are also disingenuous claims that delisting Chinese firms could “destroy over $1 trillion in market capitalization” and the like. For Chinese enterprises, market capitalization is many times the value of outstanding shares. The true loss would be in active trading of companies with few peers, which is much closer to $10 billion than $1 trillion.

The New Policy Menu

At the level of transactions worth tens or hundreds of billions of dollars – the level that matters to Beijing – Sino-American financial relations are fairly simple. US policy choices are more complicated, with now a wide range of motives. American financial gain is of course the starting point, but that has been discussed at length for 25 years. The recent focus is on reasons to curb rather than expand financial ties, including protecting the rule of law, human rights, advanced technology and national security, and retaliating against predatory economic practices.

For each of the non-financial motives, there are multiple possible goals: deterring bad behavior, outright punishment, a “level playing field”, or decoupling. Possible actions connect to those: provide public information on the Chinese entity, impose a one-time penalty, indefinitely halt one or more types of US business transactions, or seek to bankrupt the entity. These should vary with the extent of the harm caused and whether a first-time or repeat offense.

While this is messy, focusing on capital flows helps clarify. The most important aspect of merchandise import payments are their size - the most money but also the most Americans affected. Inhibiting trade on a large scale should be done only in response to large-scale harm, such as military aggression or intense rights violations. Narrower actions could be used in concert with investment or other restrictions, to better deny American money to targeted entities.

The most important aspect of direct investment is that it can convey technology, including dual-use technology. Reform of the Committee on Foreign Investment in the United States and recent expansion of the Department of Commerce’s Entity List both nominally tighten control over technology. But neither directly address American money headed to the PRC, which can either embody technology transfer itself or financially support China’s technology development.

Finally, the most important aspect of portfolio investment is its multiple channels – listings here or in the PRC, through retail funds, or by major financials. It has not yet become a political issue like trade or a national security issue like direct investment but portfolio investment can subtly undermine other actions, when American funds in some way reach and support Chinese companies that have been hit by tariffs or other sanctions.

Current Recommendations

Different motives, for example simply maximizing yields versus technology control, make for legitimate differences about whether and what steps should be taken with regard to American capital supporting PRC activities. Here are four overdue actions and one longer-term proposal, all aimed at reducing the emphasis on pure financial gain:

1) The provision of information is a core government function, and vital for sound investment decisions. Chinese entities raising capital in the US which refuse to meet American disclosure requirements threaten investors and weaken the rule of law. They should be penalized and warned of removal, then removed if necessary. It should not be legitimate for any group to argue that any Chinese firms should operate in the US without obeying the law.

2) Concerns about unwitting investment in PRC entities should also be addressed with information. The Department of State should, for this and other reasons, compile a list of Chinese entities which are proven to have broken US law or helped suppress human rights. American financial brokers should be required to attach a short, general warning to all relevant funds that may include these firms, identifying the State Department site.

3) US actions aimed at controlling technology for national security purposes should include restrictions on direct and portfolio investment. It is not sensible to decide to block technology exports to Chinese users or block Chinese acquisitions of technology firms, yet permit American capital to freely support the PRC's development in the same sectors. Beijing just agreed not to require technology transfer, so of course there will be no retaliation.[15]

4) Chinese entities which have benefited from outright theft of intellectual property are breaking US law and harming the American economy. If the technology is dual-use, they are also threatening national security. Confirmed repeat offenders of this type pose serious risks and the US should seek to put them out of business, if possible. Any exports to the US and all types of American investment should be banned, backed by criminal penalties.

5) The first four steps should be taken quickly. In the longer term, the determination of how to respond to intense Chinese subsidies and continuing industrial policy should include evaluating responsive investment and trade restrictions. When China is directing funds on a non-market basis to companies and sectors, potentially warping the global economy, the US should not ease the financial burden of doing so by providing our capital.

Finally, policy-makers should be aware that in cases of sustained and serious damaging acts by Chinese firms, the true perpetrator is probably the state. And the state can juggle the firms it is using at will. In these cases, American sanctions should be aimed more at the general behavior and less at the specific entity involved at the moment.

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15 https://ustr.gov/sites/default/files/files/agreements/phase%20one%20agreement/Economic_And_Trade_Agreement_Between_The_United_States_And_China_Text.pdf