



July/August 2010
ESSAY

Coping With China's Financial Power

Beijing's Financial Foreign Policy

Ken Miller

KEN MILLER is CEO and President of the merchant banking firm Ken Miller Capital LLC, Director of the USA Pavilion at the 2010 Shanghai World Expo, and a member of the U.S. State Department's Advisory Committee on International Economic Policy.

China's approach to economic development has turned the country into a lopsided giant, an export juggernaut with one huge financial arm. Following the reforms launched by Deng Xiaoping in 1979, Chinese businesses began using cheap labor and cheap capital to compete on the world market, with ever-increasing effectiveness. Today, Beijing continues to subsidize exports heavily. It does so directly, through favorable loans to businesses and favorable exchange rates to foreign buyers of Chinese goods. And it does so indirectly, through what economists call "financial repression," whereby the government imposes controls on the investment of Chinese citizens that allow it to funnel capital into Chinese businesses. The People's Bank of China has gathered a good portion of the enormous trade profits and cash inflows that have resulted. At the end of 2009, it held \$2.4 trillion worth of foreign exchange. This is the largest amount of foreign exchange owned by any central bank in the world -- and it does not even reflect the reserves held by China's major commercial banks. What is more, the figure is likely to grow by another \$300 billion in 2010.

Never before has China had this much financial might, and it is now experimenting with how best to use it in its relations with other states. Reintegrating Taiwan is an essential goal of China's foreign policy overall, but the principal aim of China's financial foreign policy is to stimulate economic growth and job creation at home. In pursuing this goal, the government enjoys considerable legitimacy: it is supported by the pride of a nation that is finally moving to a central place in the world order. Corruption, rising inequality, restricted freedoms, and environmental damage are challenges to the Chinese Communist Party, but the CCP's hold on power is likely to remain secure so long as it can continue to develop China's economy and create jobs.

China is at an early stage of increasing its influence in international finance, and although it sometimes sounds ambitious, it is being prudent. In March 2009, the head of the People's Bank of China called for an end to using the dollar as the world's reserve currency in favor of a new currency to be created by the International Monetary Fund. Yet there is no sign that the Chinese government intends to push this policy anytime soon. Likewise, China's moves to internationalize its currency, the renminbi, have been very incremental. It has signed currency-swap deals with Argentina, Belarus, Hong Kong, Indonesia, Malaysia, and South Korea; it began allowing certain countries to use the renminbi to pay for Chinese imports; and it now lets enterprises based in Shanghai and in four cities in the southern province of Guangdong use it to pay for imports into China. But Beijing does not dare make its capital account

convertible -- that is, let the renminbi freely convert into foreign currency (and vice versa). China's leaders may be putting Chinese nationals in senior positions at the IMF and the World Bank, thinking of participating in new regional financial bodies, and promoting the convertibility of the renminbi in regional trade, but for now they remain trapped in a dollar world.

And so for now, too, China's financial foreign policy rests on two simple strategies: accumulating foreign currency reserves and sending money abroad -- in the form of direct investment, aid, assistance, and loans -- in order to secure the raw materials, new technologies, managerial know-how, and distribution networks that will bolster domestic growth and the CCP's legitimacy.

This policy makes those who are already wary of global trade imbalances fret about how China will use its growing financial clout in the future. Many U.S. government officials and China specialists think it is highly unlikely that Beijing would use its financial power to disrupt international capital markets. But power matters even when it is not exercised. And China's unprecedented financial clout now gives Beijing influence in every aspect of the global economy.

THE WEALTH AMONG NATIONS

China's outsized foreign exchange reserves are one manifestation of the country's very high savings rate and of the severe limitations placed on opportunities to invest these savings. Chinese people still cannot send much money outside of China: it is illegal, for example, for one to invest more than 350,000 yuan (about \$50,000) a year overseas. Chinese stock markets, which trade principally on rumors and changes in government policy, are highly volatile, and the speculative housing market suffers booms and busts. Bank deposits, which are the safest place for savings, pay negative interest when one takes inflation into account.

As China's economy became more productive and as the CCP's confidence in its domestic economic plan increased over the past decade, the Chinese government started laying the groundwork for expanding its financial presence overseas. The objectives of the People's Bank of China have consistently been capital preservation first, then liquidity and profitability. In the early days of the save-and-export model, the government purchased foreign government obligations and some gold. Then, over the last decade, with the massive amount of value that accumulated, it began to experiment with new approaches to investing overseas, such as purchasing nongovernment securities. The sheer size of China's foreign reserves today, combined with the perception that these reserves will keep growing, gives China an outsized influence in international financial markets relative to its low level of per capita income.

Such huge sums give China the power to disrupt the markets for U.S. Treasuries and euro-denominated debt. Even though such interference would be self-destructive and China has been participating in the world financial markets in a sophisticated and responsible manner, critics insist on its potential to undercut the world economy. They worry that the United States would be hurt if China stopped purchasing U.S. Treasury obligations or, worse, started dumping U.S. debt. At least according to public U.S. Treasury statistics, China has been lending money to the United States for increasingly shorter periods of time. (Because U.S. Treasuries are bought through intermediaries and the process is somewhat opaque, no one can be sure of the figures.) Of the \$281 billion in U.S. securities that China added to its total holdings in 2009, as much as \$130 billion went to short-term debt. The remaining \$151 billion represented the smallest annual increase in China's holdings of long-term U.S. debt since 2004. China's cache of U.S. dollars and other reserve currencies may diminish over time, but for now, it (along with China's trade surpluses) remains a major sore point for important constituencies in the United States and Europe.

In truth, however, the United States and China are holding each other hostage. The United States needs China to buy its obligations, and for the foreseeable future, China will have few other places than the U.S. dollar to store the foreign currency value it has accumulated. According to China's National Bureau of Statistics, the country's trade surplus for 2009 was \$196 billion, down from \$298 billion in 2008, but even in 2009 there was not enough euro-denominated debt, Swiss francs, Japanese yen, and gold in the world to absorb China's reserves. China might one day decide to keep its dollars out of U.S. Treasuries, especially when interest rates are low. But under most normal circumstances, this would cause so great a decline in the value of China's dollar holdings, and thus so much financial disruption, that the regime would never make the move in the first place. Likely retaliation from the United States, in the form of trade impediments, could hurt China's economy even more, since the Chinese government's ability to provide jobs for Chinese workers depends on access to U.S. markets.

Policymakers in Washington must, of course, consider the possibility that Beijing will act in self-destructive ways. But there is also a major domestic check ensuring good financial behavior on the part of the Chinese government. The \$2.4 trillion held by the People's Bank of China is widely understood, both within the leadership in Beijing and among Chinese citizens, to be the people's money, the fruit of their incredibly hard work. The leadership suffers an avalanche of popular criticism whenever the savings are poorly invested. The only sentiment that might outweigh this is patriotic fervor -- which is why the Chinese government goes to great pains never to appear to be yielding to foreign pressure. (Western governments have been no more successful at badgering Beijing to revalue the renminbi than Google was in securing unrestricted access to the Internet for its customers in China.) All of this means that the Chinese government could not wreak havoc in the international financial system and still stay in power unless patriotism trumped the people's concern about value -- an unlikely scenario.

China's use of its foreign reserves in the international currency markets is aimed at managing the value of the renminbi -- a normal part of any country's monetary policy. Much like that of the U.S. Federal Reserve, the job of the People's Bank of China is to create a financial environment that maximizes the likelihood of full employment and stable prices at home. Moreover, China's responsible management of its reserves to date has allowed Beijing to form valuable relationships with the leading financial managers across the global economy. Beijing's normal open-market activity, the daily buying and selling of billions of dollars of financial instruments, has put it in close contact with the other major players in the multitrillion-dollar foreign exchange market. And these daily financial flows have lowered interest rates while increasing the liquidity and stability of international financial markets.

GOING OUT

Having set the stage for economic growth through its financial policies, Beijing tries to create jobs and secure the inputs it believes will stimulate domestic growth in its direct dealings with other governments. And in its bilateral foreign policy, Beijing prefers the somewhat blunt tools of direct investment, outright grants, and so-called concessional loans, loans with terms far more generous than those available on the market.

Direct investments overseas, often called "foreign direct investment" (FDI), allow a country to gain control over resources, access to technology, and information about what is happening outside its borders. The Chinese government began to encourage FDI from Chinese businesses in 1999, but this "go out" policy got off to a very slow start. At the time, China was focused on revamping its patchy state sector, and its private sector was still too weak to go out on a large scale. The policy ramped up in 2005, not long after reserves in the People's Bank of China began their upward climb and state-owned enterprises found themselves in a better position to lead the charge in investing

abroad. Then, as the need for energy and raw materials to feed China's booming economy grew, the search for resources spread worldwide.

During the go-out policy's first ten years, Asia was always an area of great interest for Chinese companies; Africa and Latin America have increasingly become so. The government has heavily promoted investments in oil and gas, mining and metals, and financial services, but also in virtually every other economic sector. Over time, the Chinese government has placed more emphasis on acquiring know-how: one of the objectives of the China National Offshore Oil Corporation (CNOOC) in trying to take over the U.S. energy giant Unocal in 2005 was to acquire technology for energy exploration and production.

Most of China's FDI comes from state-owned enterprises. Although individual businesses are increasingly taking the initiative, all large investments are still coordinated by government institutions. In the policy's early days, businesses tended to spend their own cash reserves, but today, large state-backed banks, such as the Bank of China and the Export-Import Bank of China, furnish the financial fuel. Whereas U.S. companies go out into the world in search of profits with minimal government interference or, for that matter, support, virtually all overseas investment by Chinese companies requires some level of state approval.

That said, Beijing's backing has been forthcoming. Premier Wen Jiabao announced in the government work report (loosely, the equivalent of the U.S. State of the Union address) released in March that Beijing would support qualified companies in making mergers and acquisitions overseas and give them more autonomy to invest abroad. In order to maintain absolute stewardship of the currency's value, the government tightly controls China's capital markets, which are mostly based on bank financing and plain vanilla equity issuance. Still, it is becoming easier for Chinese companies to get approval to invest abroad. Except for very large or politically sensitive deals, which require special prior review by Beijing, most projects are now given the go-ahead by local bureaus of the Ministry of Commerce and the National Development and Reform Commission within a month and a half, and the foreign exchange needed to proceed is usually made available soon after that. The government seems ever more intent on encouraging investment abroad and encouraging it in more and more areas. In its latest work plan, the Ministry of Commerce for the first time detailed an interest in overseas manufacturing, high-tech industry, clean energy, and famous brands and the desire to process resources externally rather than shipping them directly back to China, as has been the case.

Considering this interest, there is less Chinese FDI than one might expect. During 2009, Chinese companies invested only \$48 billion overseas, around one percent of Chinese GDP; U.S. companies, in comparison, invested \$340 billion, around 2.4 percent of U.S. GDP. As of the end of 2009, China's total accumulated FDI was \$211 billion, about 4.3 percent of Chinese GDP, whereas the United States' was estimated to be \$3.245 trillion, about 23 percent of U.S. GDP. At current rates, China's FDI will not catch up to the United States' until 2047. Even if the statistics on China's FDI, which come from both the Ministry of Commerce and the State Administration of Foreign Exchange, understate the amount of capital invested abroad by Chinese nationals (because of hidden reinvested profits), they nonetheless reveal a significant gap between the scale of China's overseas investment and that of the United States'.

The difference results partly from various barriers to Chinese investment outside the mainland. One of them is resentment against Chinese state-owned companies because of the perception that they are responsible for having taken jobs, even homes, away from local residents in the countries in which they invest. Chinese companies have encountered fierce resistance to several high-profile attempts to acquire foreign firms, especially in the United States. Lenovo's friendly purchase of IBM's personal-computer business for \$1.7 billion in 2005 seems like an exception.

That same year, Chevron launched a major public relations campaign to mobilize Americans' xenophobia against CNOOC, which was trying to acquire the California-based Unocal. In short order, Chevron convinced CNOOC that the U.S. Congress would oppose the sale and got it to drop its \$19 billion bid. When, in February 2008, the Australian natural-resource firm BHP Billiton attempted to take over the Australian firm Rio Tinto, the Chinese government made \$40 billion available to the Aluminum Corporation of China (Chinalco) to outbid it. It was seeking to thwart the deal because it believed that consolidation between BHP Billiton and Rio Tinto, two major suppliers of iron ore, a key ingredient in the production of the steel essential to China's infrastructure, might cause iron ore prices to shoot up. Two years later, Chinalco has managed to secure only a modest minority position in Rio Tinto's common stock, and BHP Billiton is now on track to combine its operations and Rio Tinto's in a joint venture. The Australians' chauvinistic desire to keep their largest companies out of China's sphere of influence has been a major force in this multiyear struggle. In Australia and elsewhere, Chinese companies are making some progress on small natural-resource deals, but they have encountered resistance to high-profile takeover attempts in developed economies.

Chinese FDI is also limited by skepticism about overseas investment opportunities among Chinese businesses. Many have grown wary after the dramatic failure of deals that seemed promising at first. In October 2004, the Shanghai Automotive Industry Corporation paid \$500 million for a 51 percent stake in the South Korean carmaker SsangYong Motor with grand plans for building a Chinese car that utilized South Korean technology and for turning the Shanghai Automotive Industry Corporation into a Fortune 500 company. But the investment ran into problems with unions from the start, and last year, after a series of rocky disputes with its workers, SsangYong Motor declared bankruptcy. The Shenzhen-based insurance firm Ping An hoped to gain expertise in asset management by investing in the Dutch company Fortis Group in late 2007, but in short order that attempt turned into a \$3.3 billion write-off. That year, TCL, a major Chinese television manufacturer, encountered similar misfortunes in a joint venture with Thomson Electronics in France, suffering major losses in Europe that eventually forced it to downsize, close, or sell most of its European operations.

Chinese investment abroad is further limited by the allure of better opportunities in the domestic market. The Chinese economy has grown so rapidly compared to others that it requires an unusual impetus for Chinese companies to invest elsewhere. Moreover, since English remains the international language of business and finance, the Chinese feel much more comfortable at home. They also believe that the renminbi is destined to strengthen against the other major currencies, which would impair returns on non-Chinese investments.

THE AID THAT TIES

Partly because of these dynamics, the Chinese government decided early on that it could not rely exclusively on state-owned enterprises and private-sector entrepreneurs to invest overseas. In 2007, it set up a sovereign wealth fund, the China Investment Corporation, with an initial capitalization of \$200 billion. After a few early stumbles investing with the Blackstone Group and Morgan Stanley and, during the recent world financial crisis, losses in the supposedly safe Reserve Primary Fund, the CIC seems to have found its footing. It enjoyed a 17 percent return on investment in 2009, and it now has over \$300 billion under management, with more funds likely to be made available. The CIC is allocating capital to proven non-Chinese money managers and individual companies active in sectors such as natural resources and technology. Beijing has also established other smaller multibillion-dollar funds to invest directly in Asia and Africa. Both the State Administration of Foreign Exchange, which manages China's foreign exchange reserves, and China's national pension fund have begun to select foreign private-equity and hedge-fund asset managers.

Similarly, a key dimension of China's go-out policy is to award grants, aid, and concessional loans to foreign governments in support of specific projects and to require in exchange that they hire only specified Chinese companies to do the work. Numbers published by China's Ministry of Finance suggest that outright grants and foreign aid (excluding military assistance) from Beijing totaled less than \$2 billion last year (compared with \$28 billion for the United States). Pure aid from China takes the form of medical and technical assistance, scholarships, investments in Chinese-language programs, or funds for turnkey plants. Unlike the U.S. government, the Chinese government gives aid without any conditions relating to human rights or democracy promotion. Rather, its aid is tied to particular projects: the construction of a port, a railroad, a pipeline, a sports facility.

China treats the information about the amount and the beneficiaries of its grants and loans as a state secret. But based on 2007 figures (the most recently published) from the Export-Import Bank of China, the largest source of China's concessional loans, Beijing probably made some \$10 billion worth of such loans last year. A typical go-out project might involve both a direct investment by a state-owned enterprise and a concessional loan to a foreign business or government at below-market interest rates, with grace periods and long repayment terms. (To call these loans "concessional" is somewhat misleading: more than just offering favorable terms, they often provide capital for projects that could not be financed otherwise.) Like Beijing's grants and aid, its concessional loans usually require the recipients to hire Chinese companies to conduct the underlying projects. For instance, the Export-Import Bank of China is providing 85 percent of the \$1 billion of financing for a new port in Hambantota, Sri Lanka, which the state-owned enterprise China Harbour Engineering is building. The Chinese government has similarly supported the development of port facilities in Bangladesh, Myanmar (also known as Burma), and Pakistan; railroad lines in Nepal; roads and sports stadiums all over Africa; and other big infrastructure projects throughout Latin America. As many as 750,000 Chinese from mainland China may now be working outside of China proper on projects financed by the Chinese government.

In some ways, Beijing is behaving much like Washington in assisting its domestic businesses in overseas ventures. The U.S. Overseas Private Investment Corporation also has programs that insure and finance U.S. businesses operating in over 150 countries. But U.S. companies pursue profit more single-mindedly than do their Chinese counterparts. And if U.S. companies often benefit from their government's foreign policy, these companies, unlike their Chinese counterparts, are not its leading edge. The Chinese government, on the other hand, so thoroughly mixes government-to-government aid with various incentives for Chinese businesses to acquire assets abroad that its financial foreign policy can seem nakedly mercantilist. As many as half of the professionals in the Chinese Foreign Ministry are said to be working on economic matters.

The fact that these government-to-government agreements are undisclosed and that contracts for projects are awarded without an open bidding process creates concerns about corruption. Anecdotal evidence also suggests that China's tied-aid approach is encountering resistance in recipient countries as a result of some projects' environmental impact and relatively small lasting economic contributions. The requirement to employ imported Chinese labor means limited benefits to local economies, especially as the Chinese workers' pay is typically deposited into bank accounts in China. In the face of such worries and objections, Beijing may someday decide to change its ways.

MATURE DEBT

As China invests more and more savings abroad, it will likely project its financial power differently. It would be a big breakthrough, not to mention an immense help in redressing global imbalances, if China invested more in developed economies. Since Chinese businesses that invest abroad will continue to be seen as extensions of the state

until China adopts a more open economic model at home, Chinese financiers would do well for now to make loans rather than buy equity when they invest in developed economies. And when they do buy equity, they should do so in companies that are not publically traded; it is easier to buy closely held companies without causing a brouhaha. This lesson appears to be slowly sinking in: since CNOOC's failure to buy Unocal, some Chinese bidders have started showing up at private auctions for closely held U.S. energy properties.

It would indeed help if Beijing played the role of creditor more often. Chinese commercial banks seem unsure about their ability to conduct credit analysis for foreign companies and feel more comfortable serving the Chinese community. But by becoming direct lenders to non-Chinese businesses, they would acquire just as much know-how and more influence than if they were minority shareholders. Since loans are not seen as power grabs, the transactions would probably encounter little political resistance. The capital would go directly into the borrower's business rather than to its shareholders, and it would provide jobs, as well as stimulate the local economy. As a creditor, the Chinese government would hold a more senior and safer position than as an equity owner.

As the Chinese economy matures and becomes more oriented toward consumption and services, changes should be expected. The CIC's September 2009 decision to acquire a debt-like instrument worth \$1.9 billion from Bumi Resources, Indonesia's largest coal company, is a sign that Beijing is beginning to adjust its go-out strategy. Right now, too many Chinese are too close to the poverty level for the leadership to support openly the use of national resources to achieve nonmercantilist objectives overseas. But down the road, Beijing may become less intent on using aid, grants, and concessional loans abroad so directly in the service of China's domestic economy. This may especially become the case if the regime could feel more secure in other ways, militarily, for example.

But this is not certain. No one knows, for instance, whether the Chinese government would allow capital to move in and out of the country without government involvement. Such liberalization, which would likely come with more leeway in investment decisions for individuals and companies, would be a drastic change in China's financial foreign policy. Were it to happen, business decisions would then be driven less by political considerations than by purely economic assessments of risks and rewards. Chinese companies would grow through mergers and acquisitions. National companies and national brands would emerge, with solid platforms for international expansion. At that point, China would begin to project the power of its domestic markets into the global arena, much as the United States and Europe do: through multinational corporations. This, in turn, would improve China's image in the developing nations in which it invested by limiting criticism from local populations who before suspected that its deals were motivated by the Chinese government's political objectives.

Another open question is how soon Beijing will allow the renminbi to become an international unit of account, a medium of exchange, and a store of value, like the dollar and the euro. Capital account convertibility would increase the influence of China's international financial position immensely. Shanghai could become a major financial center, like New York and London, and Chinese financial institutions would be able to compete internationally. Today, Shanghai already boasts a good telecommunications infrastructure, which could readily be upgraded to world-class standards -- a necessity if Shanghai is to become a major financial center. And there is plenty of Chinese human capital abroad trained in the global financial markets ready to be lured back to the motherland.

But only capital account convertibility and the ability to deal internationally in renminbi would give Shanghai a serious competitive advantage and a chance to become a global financial hub -- and these are tricky propositions. One of the functions of the State Administration of Foreign Exchange is "to study and implement policy measures for the gradual advancement of the convertibility of the RMB [renminbi]." But the process has been slow. Without

existing currency restrictions, Chinese capital would flow both within the country and overseas to investments that offered the highest returns, and cheap capital, one of the engines of the Chinese miracle, would disappear. Higher capital costs and stiffer competition would hurt export-dependent businesses in China, which could lead to considerable domestic disruption. Free capital flows would quite naturally create big agglomerations of economic power -- and possibly a counterpoise to the CCP. These significant risks suggest that as fundamental a change as currency convertibility is probably a long way off.

NEW KID ON THE BLOCK

Many of the economic issues between the United States and China relate to currency policy, jobs, and associated financial imbalances. The Obama administration has announced plans to double U.S. exports over the next five years, an effort that is likely to create more competition for third markets and additional conflicts between Washington and Beijing. At worst, such a development could thwart the process of liberalization that China will naturally undergo as it continues to develop economically. Fortunately, Washington seems to understand that encouraging China to play an important role in international financial stability is very much in the United States' interest. It has made clear, for example, that it welcomes Beijing at the international financial table -- as well it should.

So far, China's financial foreign policy has been good for other countries and less beneficial for China itself than first meets the eye. China is buying U.S. debt. It is helping make orderly markets. Its FDI is helping it learn about the outside world. As for Beijing's aid and assistance to developing countries, the amounts involved are small to begin with, and the Chinese government is generating a fair bit of resentment. Its mercantilist approach will not give the government any more real security over sources of supply than if it bought them at international prices on the open market, and in the fullness of time, as the Chinese government recognizes this, it is likely to shift its tack without external pressure. Thus, with the important exception of China's support for regimes that the U.S. government does not like, Washington should not worry much about Beijing's financial foreign policy.

As China stimulates its domestic demand and becomes a bigger player in international finance, its engagement will most likely contribute to healthy relations among nations. The developed economies' need for capital and China's surfeit of it will give China a natural path to invest in those states (even without capital account convertibility). Larger financial ownership positions in foreign companies will, on balance, be a good thing for Chinese companies and for the world, just as the United States' stock of foreign investments has been. And if Western capitalism continues to show vitality, China will likely evolve to be even more market-oriented. After all, the Chinese appetite for profit making has survived nicely despite over 60 years of communist rule.

A little bit of patience is in order. Policymakers in the United States should remember that China emerged as a financial power less than ten years ago. With a better understanding of China's domestic imperatives, Washington can encourage Beijing to project its financial power abroad in ways that contribute to the stability of the global economy.

Copyright © 2002-2010 by the Council on Foreign Relations, Inc.
All rights reserved.

Return to Article: <http://www.foreignaffairs.com/articles/66466/ken-miller/coping-with-chinas-financial-power>
[Home](#) > [Essay](#) > [Coping With China's Financial Power](#)
Published on *Foreign Affairs* (<http://www.foreignaffairs.com>)