In Case You Missed It: CSOP's Weekly China Wrap-Up

One Belt, One Road Summit concludes in Beijing

President Xi hosted leaders from 29 countries at the Belt and Road Forum for International Cooperation, China's biggest diplomatic event of the year. During the summit, Xi pledged over USD 100 billion in new funding while China sealed 30 trade and investment deals.

China's grand plan

Xi created the One Belt, One Road (OBOR) plan four years ago, envisioning a Silk Road network of trade and infrastructure linkages to connect 65% of the world's population in countries across Asia, Europe, and Africa. China-backed institutions such as the Asian Infrastructure Investment Bank, New Development Bank, and Silk Road Fund are instrumental to funding the vision, though longstanding Western institutions such as the World Bank and International Monetary Fund have endorsed the project as well.

Although some onlookers argue that China is using OBOR to consolidate regional influence and export excess debt and manufacturing capacity, the project is also hailed as an important counterbalance against the resurgence of Western nationalism and isolationism. It has attracted interest from emerging and developed economies alike seeking Chinese capital to upgrade failing and non-existent infrastructure.

US role in OBOR?

Although the United States has long hesitated to partake in the initiative, the recent defrosting of Trump-Xi relations has led to increased participation. The US efforts are being spearheaded by the American Belt and Road Working Group, a partnership between US companies and the US embassy in Beijing. Matt Pottinger, the National Security Council member leading the delegation, affirmed that US firms have a long and successful track record in global infrastructure development and stand ready to contribute.

Some critics charged that the new US role deviates from Trump's anti-globalist, anti-China campaign rhetoric, while others propose that US involvement supports Trump's promise to create domestic jobs. While onlookers are generally heartened by the US-China cooperation, they also urge China to promise that projects are transparent and fair for both Chinese and foreign companies.

US and China reach trade deal following April Mar-A-Lago summit

In accordance with the post-Mar-A-Lago 100 day plan, the United States and China have reached a 10-point deal to address China's USD 350 billion trade surplus.[1] The deal focuses primarily on energy, agriculture, and China's financial markets, while ignoring more contentious items such as steel, aluminum, and auto parts.

Deal highlights:

1. **Energy**: Under the agreement, China will accept US shipments of liquefied natural gas (LNG). US energy companies have long salivated at the profit opportunity, as China's consumption of the clean fuel is expected to grow 5.4% per year.
2. **Agriculture**: China will allow beef imports from the US, lifting the 14-year ban in place since the Mad Cow Disease outbreak of 2003. In exchange, the US will accept cooked chicken products from China.

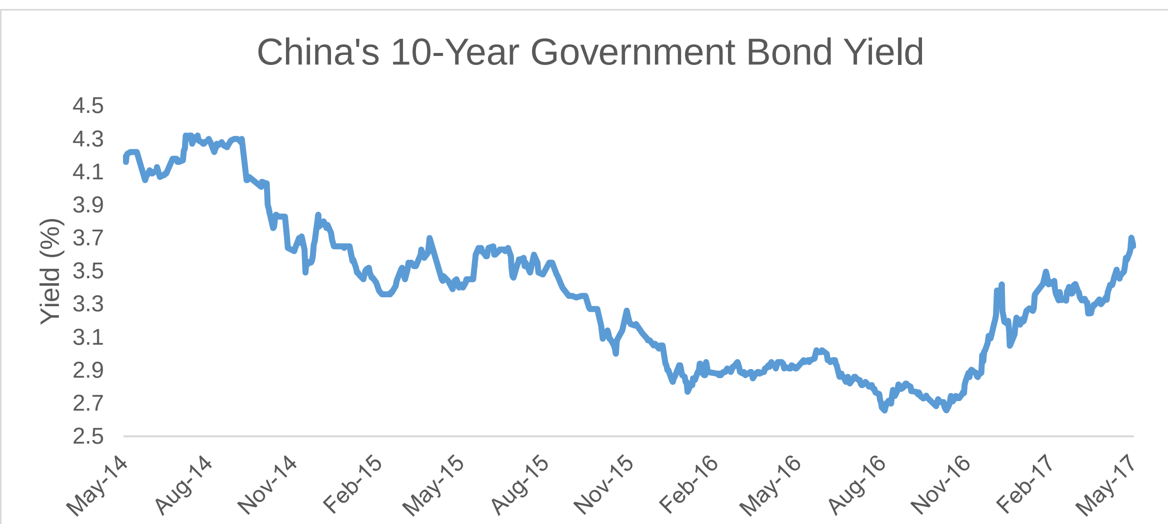
3. **Financial Services:** The trade deal also grants US financial service providers better access to China. US rating agencies will be permitted to provide rating services in China, while US brokerage firms can grant licenses to underwrite bonds. In addition, US card payment companies will be allowed to compete with UnionPay, the state-supported behemoth that has long monopolized China's payment infrastructure.
4. **Attendance at OBOR summit:** The United States has agreed to send a delegation to the One Belt, One Road summit, led by the Asia-focused National Security Council member Matthew Pottinger. US attendance is a major coup for China. President Xi has long sought Western approval for his signature initiative, which previous administrations have ignored.

Sino-US trade war becomes unlikely

Although the specter of a trade war has haunted global investors since Trump's November 2016 victory, the possibility of a protectionist skirmish has diminished greatly given the deal and recent events. After the Trump administration refused to label China a currency manipulator in April, China began cooperating to calm tensions on the Korean Peninsula. However, it remains uncertain if and how the countries will structure future trade agreements to address more controversial items such as steel, aluminum, and auto parts.

Xi's financial stability promises lead to tightening, reminiscent of 2013 liquidity crunch

China's leadership organized a "group study meeting" of the 25-member Politburo to devise recommendations for reducing leverage in China's economy. It is believed that the meeting, which brought together heads of the CBRC, CSRC, PBOC, and CIRC, motivated last week's withdrawal of net RMB 120 billion through open market operations.[2,3,4,5,6] As a result, 10-year government bond yields hovered around 3.66%, the highest yield in more than two years.



Source: Bloomberg, as of 5.12.2017

What are the similarities between the current tightening and the liquidity crisis of 2013?

The current tightening efforts are reminiscent of the PBOC-engineered liquidity crunch of 2013, when overnight borrowing costs reached 30%. Although today's overnight rates are significantly lower—closer to 5%—both events were nonetheless regulator-driven attempts to reduce leverage during stable domestic economic conditions. Macroeconomic data was supportive in both instances, affording regulators the confidence to pursue aggressive deleveraging.

To refresh investors' memories, the PBOC declined to inject liquidity in June 2013 in attempt to reduce credit growth and punish overextended speculators. The shadow banking sector had been growing rapidly at that time; small banks and trust companies borrowed from state banks and lent to corporates and real estate firms at high rates, fueling speculation. Stripped of easy money, banks and traders scrambled to cover positions as rumors of Wealth Management Product defaults swirled. Interbank rates soared as the PBOC sat back to communicate its seriousness, intervening eventually after several days of market panic.

A similar spring cleaning is occurring today as Beijing attempts again to mitigate risky lending practices. Last week, China's securities watchdog ordered brokers to halt their asset pool businesses, which had allowed banks to gain off-balance-sheet exposure to risky assets. By shrinking the pool business, the PBOC is forcing market players to liquidate underlying assets, effectively pushing rates higher and stripping the system of liquidity.

What are the differences?

The liquidity crisis in 2013 was driven by PBOC, while the current iteration seems orchestrated by President Xi, considering his recent proclamations and policy consistency among PBOC, CIRC, CBRC and CSRC. This coordinated campaign has potential downsides, however. Some onlookers assert that the financial deleveraging coupled with the anti-corruption campaign might result in even more damage than the 2013 tightening.

Liberal candidate Moon Jae-in wins South Korea election, promises warmer relations with North Korea and China

Liberal candidate Moon Jae-in handedly won South Korea's election last week, a victory that heralds the end of a conservative decade. Moon advocates for closer ties with North Korea and China, a marked departure from the stance held by impeached president Park Geun-hye.

Who is Moon?

Born into a family that escaped the North Korea regime, Moon embraced political activism at an early age. He was jailed as a student leader in 1970s for protesting against Park Chung-hee, authoritarian president and father of the fallen Park Geun-hye. After university, Moon became a famed human rights lawyer before serving as chief of staff to liberal president Roh Moo-hyun. He lost to Park Guen-hye in the 2012 Presidential election, though benefitted in her downfall by positioning himself as a reformist and the only candidate who could reunite the bitterly-divided country.

Impact of Moon's victory on China

Moon's political views represent a sharp contrast to those of his predecessor. While Park severed almost all ties with North Korea, Moon favors communication and cooperation with Pyongyang, evidenced by his support of a joint North-South Korea industrial project. Due to these views, North Korea indicated its preference for Moon before the election.

In addition, Moon is wary about deploying the US-sponsored THAAD anti-missile system on South Korean soil, promising to renegotiate with the US and China to find a more agreeable solution.[7] Park's support of the controversial system angered China, whose citizens boycotted South Korean products and travel after the system was announced. All told, onlookers expect Moon's administration will both ease the current tensions with China and make South Korea less beholden to US strategic objectives.

Macron wins French presidency, a boon for China

Centrist candidate Emmanuel Macron decisively defeated the far-right Marine Le Pen to win the French election. Leaders around the world—including the US and China—applauded his victory, while investors expressed relief that another Brexit had been avoided, at least temporarily.

Impact of Macron's victory on China

In contrast to Le Pen and the rise of Western populists, Macron believes that global trade and cooperation is in the best interest of France. He recognized the importance of a friendly relationship with China during his tenure as economic minister from 2014 to 2016. In his pre-election interview with state media Xinhua, Macron emphasized the need to promote heightened Sino-French cooperation in nuclear development, climate change, and educational exchanges—a view consistent with China's recent advocacy for international trade and cooperation on climate issues.

Notes:

1. USD: US Dollar, the official currency of the United States
2. CBRC: China Banking Regulatory Commission
3. CSRC: China Securities Regulatory Commission
4. PBOC: People's Bank of China
5. CIRC: China Insurance Regulatory Commission
6. RMB: Renminbi, the official currency of the People's Republic of China
7. THAAD: Terminal High Altitude Area Defense, a United States Army anti-ballistic missile system