China: The New Colonialism?

The United States and China will hold a Strategic Economic Dialogue during the last week of July. The talks were an initiative of former Treasury Secretary Hank Paulson, but have continued under President Barrack Obama and Treasury Secretary Tim Geithner.

However, China, with the help of the media and many observers have wrested control of the agenda in the court of public opinion, if not the actual substantive part of the dialogue. Previously, at nearly every international economic forum, US officials harangued China to allow its currency to become flexible so it could appreciate.

The renminbi's appreciation was demanded by US lawmakers, who have repeatedly tried to pass legislation that threatened greater sanctions if China refused. The appreciation of the renminbi was desired not for its own sake, but to help ensure that China's emergence on the economic world stage is less disruptive. The artificially under-valued currency was exacerbating global imbalances, provided China with an unfair advantage, and fanned the flames of protectionism.

That was Then, This is Now

Since the end of the first quarter, China, tired of being on the defensive, went on the offensive. It began using international forums to press for reform of the monetary order which gives the dollar a privileged role. The head of China's central bank proposed expanding the role of Special Drawing Rights, a weighted-basket of dollars, euros, sterling, and yen. The IMF has used SDR, for official transactions over the last few decades, but only in a very limited fashion.

Even though other Chinese officials, including the ambassador to the United States, played down the seriousness of the proposal and European and Japanese officials were nonplussed, the feint by China worked. The media and many analysts have taken the bit and are running with it.

As the next round of SED talks are at hand, pundits are discussing the demise of the dollar and the U.S. role in the world economy. This topic gets lumped together with the diversification of reserves, which, according to the most authoritative data from the IMF, is not really taking place. The dollar today accounts for roughly two-thirds of the world's reserves, largely unchanged from the early 1990s, before the run-up to EMU.

Remember EMU? The European Economic and Monetary Union and creation of the euro were embraced by many as the first real alternative to the US dollar. Prior to EMU, the ECU, a weighted basket of European currencies, the German mark and French franc accounted for about a quarter of the world's reserves. The euro, accounting for the same amount today, has not challenged the role of the dollar as the numeraire. It is simply the sum of its parts.

Nor has the Chinese talk been sparked by a dollar crisis. Indeed, over the past four quarters, the euro has fallen 11% against the dollar, sterling is off 17%, and the Australian dollar has depreciated 16%. The Norwegian krone, which some analysts claimed could be a safe haven, has lost more than a fifth of its value.

There is only one G10 currency that has gained against the greenback over this time, Japanese yen. Ironically, to the extent that IMF reserve data shows a shift in the currency allocation of reserves, it is away from the Japanese yen and toward the British pound.

Europe is engaged in the great experiment of our time. Can economic and monetary union be sustained without political union? A decade is too short of a time period for judgment. Yet the talk about a new international reserve asset to supplant the dollar begs similar questions. Taken to its logical conclusion, China's proposal would have Europe's experiment imposed on the rest of the world. Who would determine the amount of reserve assets to make available and set its interest rate? What would take the function of the U.S. Treasury market, in which most reserves are kept?

An Embarrassment of Riches

Contrary to what passes as conventional wisdom, China is a poor country. Its economy is far too small to support such a large population. Using an assessment of fair value for the Chinese renminbi (purchasing power parity), the IMF estimates that last year, China's per capita GDP ranked 100th at about $5,963. That same per capita figure ranked China 89th, by the World Bank's calculation. The CIA rounded the per capita GDP to $6,000 and ranked China 106th on its tally.

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It has over $2 trillion in reserves. In the days before the SED, China's Premier, Wen Jiabao, appeared to announce a new initiative. Reserves would not be used to improve the lot of the Chinese people through things like education, social security, unemployment compensation, health car, or improved living conditions.

Instead, Premier Wen announced reserves would be to support and accelerate the overseas expansion and acquisitions by Chinese companies. Chinese companies have reportedly gone on quite a shopping spree in recent months (see Business Week's July 27th cover story), but this was the first time a senior Chinese official linked the "going out" strategy with the vast reserves.

Ironically, the day before Wen announced the initiative, the Financial Times ran a story, based on a report by Deutsche Bank that sovereign wealth funds, set up by central banks to better manage their reserve holdings, have taken substantial losses during the financial crisis. Deutsche Bank estimates that sovereign wealth funds lost around $600 billion since the end of 2007, or 20% of the estimated $3 trillion they held. The losses were attributed to sharp declines in equities and real estate values. These losses prompted Deutsche Bank to cut the expected growth in sovereign wealth funds to $7 trillion in 2019 from its forecast of just two years ago of $10 trillion by 2016.

It turns out that asset managers at central banks do not perform better than large private sector fund managers. Indeed, China's investments do not appear to have fared much better. Nor have its purchases always been linked to strategic importance, like the stake it took in Diageo, the distiller. Moreover, as Chinalco's failed attempt to take a bigger stake in the Anglo-Australian Rio Tinto demonstrated, there are limits to how much countries will tolerate an expansion of businesses owned by foreign states in their economies.

While some observers have tried to cast Wen's initiative as another effort to diversify reserves away from the dollar, like the IMF's SDR bond offering, the scale is off by an enormous magnitude. China's outward bound foreign direct investment was just shy of $41 billion last year. China's reserves have grown in value by more than $330 billion since the middle of 2008.

Imperialism of the eighteenth and nineteenth century consisted of Britain, France, Holland, Spain, other European powers, and Japan entering Africa, South America, and parts of Asia, for the main purpose of extracting minerals. This extraction occasionally required some modest infra-structure improvement, like a railroad or a deeper port. China is arguably engaged in a 21st century version of the same thing.

Even if only part of its current reserves are earmarked for foreign acquisitions, as if Wen was going to really operationalize his proposal, China could buy all the shares listed on Brazil's Bovespa, Australia's ASX 200, or Switzerland's Market Index. Alternatively, China could buy the entire market cap of Mexico, Chile, South Africa, and Russia combined.

China's thirst for raw materials and commodities may provide developing countries with some needed funds and without the conditions often imposed by multilateral lenders or other investors. However, this does not lead to development anymore than 18th and 19th century imperialism did. It prevents the economic diversification away from low value-added commodity extraction. It often doesn't lead to employment opportunities as China often exports workers to operate projects. Considering China's purchase of farm land in Africa, some estimate by the end of next year there will be over a million Chinese farm workers in Africa.

Conclusion

In March, China announced that beginning in May only provincial authority was needed to approve outgoing foreign direct investment in excess of $100 million. Starting in August, Chinese companies will be allowed to purchase currencies to fund foreign acquisitions. Chinese outbound investment will no doubt increase. Yet, it will not be sufficient to address China's embarrassment of riches and its humongous reserve accumulation.

The more the media and analysts accept at face value China's urging for reform of the international monetary order and desire for a dollar replacement, the less time and energy will be spent on examining the real issues, like re-pegging the renminbi to the dollar, the fact that domestic demand accounts for a smaller percentage of the Chinese economy now than a few years ago, or that its foreign direct investment policies look a lot like old fashioned imperialism.

Where ever capitalism grows the fastest, there will be crisis. China's rapid growth is indeed impressive, but it has not repealed the laws of economic development. It is producing excesses and this will lead to a crisis. Its currency is not convertible and is in no position to rival the dollar, or the euro for that matter in any kind of time horizon that makes sense for private investors.

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