ILLUSTRATION: BINAY SINHA

China renews focus on financial self-reliance

The war in Ukraine has added urgency to its plans to internationalise the yuan and establish an alternative inter-bank messaging service

"If the West cripples Russia, China could be next." This is a stark warning from a Chinese commentator. There is shock over the freezing, at a stroke, of nearly $300 billion of Russia's $630 billion of foreign exchange reserves and the cutting off of most Russian banks, including its Central Bank, from the SWIFT inter-bank messaging service through which most international banking transactions are routed.

The rapidity with which Russia has been unplugged from the global economy, in particular, from the global financial system, has shaken Chinese policymakers. The ongoing Ukraine war has highlighted the acute risks China continues to face because there are no credible alternatives to a US dollar dominated global financial system. China holds $1 trillion in US Treasury securities and more than 50 per cent of its foreign exchange reserves are denominated in US dollars. These holdings are now being seen as a serious vulnerability as the US is accused of "weaponising the global financial order." There is now renewed commentary about the urgency of achieving the internationalisation of the Chinese currency, the yuan, and establishing an alternative inter-bank messaging service.

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In 2015, China set up the Cross-Border Interbank Payment System (CIPS) as a rival to SWIFT, but it has not made any significant progress. Daily messaging under CIPS has barely reached 14,000 while SWIFT handles 40 million messages a day. CIPS has compromised by linking itself with SWIFT through a memorandum of understanding in order to plug into the more comprehensive international inter-bank network. More recently, China's Central Bank set up a joint venture with SWIFT in Beijing, with CIPS as one of the shareholders. The stated objective of the new venture, called the Financial Gateway Information Services, is to promote yuan internationalisation and the development of a cross-border payment system based on China's digital currency, the e-yuan.

Wang Yongli, a former vice-president of the Bank of China, explained the importance of the joint venture: "We should actively extend CIPS to SWIFT member units with the help of SWIFT to establish a global yuan clearing and settlement system. After that, even if SWIFT cuts off connection with China in extreme cases, it will not be difficult to form an alternative messaging service."

It is not clear why SWIFT should be helping out the Chinese to rival its own services.

It is not the messaging service per se which is the problem. It is the non-convertibility of the Chinese yuan. The Chinese government does not want to embrace the full convertibility of its currency because of fears of volatility. It is not ready to give up its control over capital flows. Chinese economists believe that the sovereign digital currency, the e-yuan, offers the prospect of convertibility without volatility. Wang Yongli spells this out,

"The e-yuan will make cross-border payments cheaper and more efficient, so in this sense, it is likely to be superior to the existing system of correspondent banking and the CIPS."

As can be seen, the setting up of an alternative messaging system is linked to the propagation of the e-yuan as an international currency.

China has achieved greater success in encouraging the use of the yuan in trade in goods and services. In 2019, 13.4 per cent of goods trade and 23.8 per cent of services trade were settled in yuan.

Chinese policymakers are aware that these initiatives may bear fruit only in the long run and will not help in dealing with a more immediate crisis. The vice-dean of the Beijing University Law School, Guo Li, has suggested how China should go about reducing its vulnerability to a cut-off similar to the one that has been inflicted on Russia. In the short term, he says, special banks may be set up to handle sanctions-related businesses; there could also be recourse to barter arrangements. In the medium term, the CIPS and digital yuan should be promoted. In the long term, he suggests China must work to "dismantle the US centred financial system."

China's digital yuan continues to be in a pilot stage. It has been reported that currently 20.8 million individuals have a virtual wallet that stores the digital currency. The volume of transactions through the e-yuan has reached 34.5 billion yuans or about $5 billion, a mere drop in the ocean. There is, therefore, a long journey ahead.

How practical these steps will prove to be remains to be seen. The renewed focus on them is clearly triggered by mounting concerns that in a confrontation with the US, China will be acutely vulnerable to financial sanctions.

A Chinese commentator, Shih Yinhong reflects this anxiety in the following comment, "The general consensus is that CIPS cannot solve the problem at all in the absence of SWIFT and China will not risk suffering sanctions by helping Russia out."

Despite Chinese efforts to achieve relative self-reliance in its financial system, the country continues to attract significant foreign investment and financial flows. In 2021, despite the pandemic, foreign direct investment to China was an impressive $182 billion. More importantly, the newly liberalised Chinese bond market, worth an estimated $16 trillion, is attracting large inflows. The volume of bonds held by international institutions in the inter-bank market reached around $600 billion, a jump of 23 per cent over the previous year. This volume will continue to grow as Chinese bonds are included in international bond indices. China has just entered the FTSE Russell World Government Bond Index and will, therefore, attract a large amount of passive funds. There may be decoupling with the US in trade and technology but the coupling seems to get stronger in the financial sector. It is large US financial firms that are taking a bet on China's financial market. Perhaps Chinese policymakers believe that the greater their exposure to China, the more influence they would bring to bear on the US administration and prevent a more serious "decoupling."

The Ukraine crisis has increased China's sense of vulnerability and the recent outbreak of Covid infections in several large cities has caused major economic disruptions. The prolonged lockdown in Shanghai, the world's biggest container port and China's most important manufacturing and commercial hub, will inevitably lead to a slowdown in growth. It is unlikely that the target of 5.5 per cent GDP growth for the year will be achieved. This may also create serious political headwinds as the country gets ready for the much anticipated and crucial 20th Party Congress in autumn this year.

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