FOR PROFESSIONAL INVESTORS – 18 December 2024

Chi on China

THE RENMINBI'S CREEPING INTERNATIONALISATION (V): 'A DOLLAR FOR A DOLLAR' STRATEGY

The supreme art of war is to subdue the enemy without fighting.

Sun Tzu

SUMMARY

- China's recent issuance of US-dollar denominated sovereign bonds in Saudi Arabia could be seen as another creeping step of renminbi internationalisation, expanding China's geopolitical influence through "a dollar for a dollar' strategy that could challenge the USD hegemony in the long-term.
- As China issues more dollar sovereign bonds at rates comparable to US Treasuries, it may redirect demand for USD bonds away from the US to Chinese bonds, making it harder for the US to fund its twin deficits and strengthening China's influence in the global dollar system.
- The Belt and Road Initiative could become a crucial tool for such strategy if and when China lends to developing economies the dollar proceeds it raises from issuing bonds in dollars and have them repaid in renminbi.

China issued USD2 billion sovereign bonds in Riyadh, Saudia Arabia, on 20 November 2024. While there were no global market reactions, there could be far reaching implications on the USD bond market (and by implication funding for the US twin deficits). It is, arguably, a signal of progress for the renminbi's internationalisation and expansion of China's global influence in the long-term.

The dollar sovereign bond issue raises some intriguing thoughts. Firstly, the Chinese bonds, with maturities of three and five years, were almost 20 times oversubscribed, compared to the usual over-subscription rate of two to three times for US Treasury bond auctions. Such strong demand for USD Chinese sovereign debt seems to underscore a global risk diversification out of US dollar.

Secondly, the interest rate spread of the Chinese bonds were just one to three basis points over that of comparable US Treasuries. This implies that China (with an S&P credit rating of A+/A-1) was able to borrow in US dollar at almost the same rate as the US government (with a higher S&P credit rating of AA+/A-1).

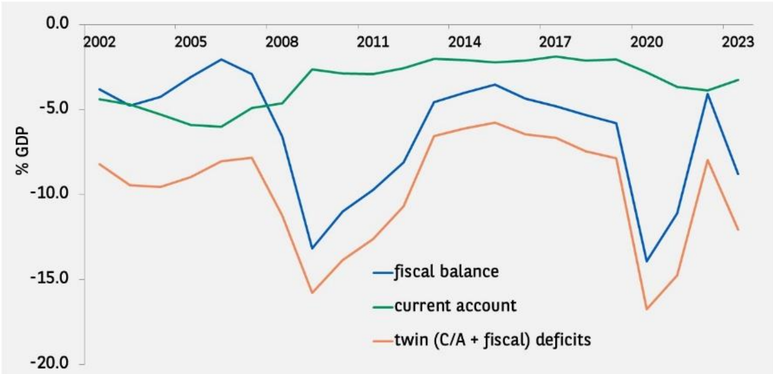
Thirdly, the Chinese bonds were issued in Riyadh – an unusual move as sovereign bonds are typically issued in major financial centres. This could mean closer ties between Saudi Arabia and China which have been in talks about renminbi-based bilateral oil trading.

ERODING FUNDING FOR THE US'S TWIN DEFICITS

Crucially, by issuing dollar bonds in a small financial centre, China is directly competing with US Treasuries for funding by paying almost the same interest rate. This has two implications. Firstly, the strong demand for the Chinese bonds seems to signal that China could eventually become an alternative manager of dollar liquidity in the global system.

Secondly, if China starts issuing more dollar sovereign bonds and can price them at rates similar to those on US Treasuries, it will provide an option for investors and countries to invest their dollars in Chinese government bonds. Given the stock of dollars, one that goes to Chinese bonds instead of US Treasuries is a dollar less for financing the US's massive (12.1% of GDP) twin deficits (Exhibit 1).

Exhibit 1
US twin deficits require persistent funding from the world's saving



sources: IMF, CEIC, BNP Paribas Asset Management 12 Dec 2024

Since the US government needs to constantly sell Treasury bonds to fund these deficits, the emergence of China as a dollar sovereign bond could potentially pose financial problems for the US government and, eventually, erode the US's 'exorbitant privilege'.

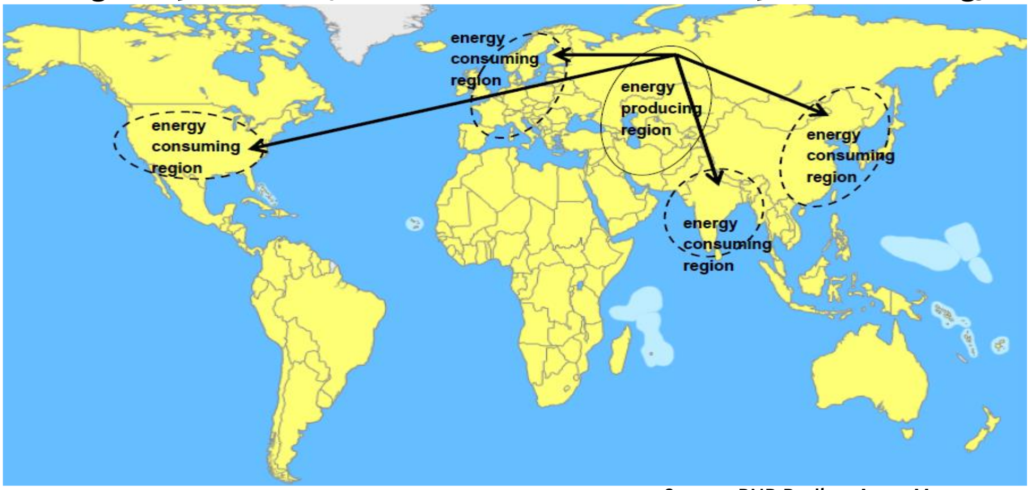
MORE CREEPING INTERNATIONALISATION

China's choice of issuing the USD-denominated sovereign bonds in Riyadh and the fact that the Saudis agreed to it can be seen as another step nudging renminbi internationalisation forward. The importance lies in Saudia Arabia's role in the global 'petrodollar' system. The success of China's recent dollar bond issuance in a small financial centre demonstrates that China had already amassed sufficient influence to redirect USD liquidity in the heart of the petrodollar system.

The global oil market, arguably, is a centrepiece of China's RMB internationalisation strategy (see Chi on China: "The Renminbi's Creeping Internationalisation: The Boiling Frog Fable", 13 April 2022). Since its talks with Saudi Arabia in 2018 about settling bilateral oil trade in renminbi, China has been preparing for a gradual shift in the global oil trade to the RMB from the dollar, eventually creating a 'petroyuan' and, by corollary, undermining the dollar's supremacy (see also Chi on China: "The Renminbi's Creeping Internationalisation (II): The Petro-Yuan and the Role of Gold", 4 January 2023).

The Middle East is of particular strategic importance to China's game plan due to its connectivity with the major oil-consuming regions. Establishing a major influence in the Middle East will give China an edge in trading with the major energy consumers on the Belt and Road Initiative (BRI) route and beyond (Exhibit 2).

Exhibit 2:
Strategic importance of the Middle East in China's expansion strategy



Source: BNP Paribas Asset Management

The Russo-Ukraine war since 2022 has added momentum to China's RMB internationalisation effort. US sanctions have pushed Russia to trade with China (including in oil) using the RMB via China's Cross-border Interbank Payment System (CIPS) at the expense of the USD-dominated SWIFT system.

In early 2023, a series of bilateral events, involving China with Brazil, Saudi Arabia, France and ASEAN countries, and the expansion of the BRICS group in early 2024 (see Chi Time: "The Renminbi's Creeping Internationalisation (IV): BRICS Expansion and the Rise of Africa", 26 September 2023) showed that Beijing had been making progress on renminbi internationalisation with its 'salami-slicing tactics (see Chi on China: "The Renminbi's Creeping Internationalisation (III): The Salami-Slicing Tactics", 12 April 2023).

'A DOLLAR FOR A DOLLAR' STRATEGY

The option for Saudi Arabia and other oil producing countries to invest their billions of dollars of reserves in the Chinese government instead of the US government suggests that China could effectively use the US dollar to hit back at the US in the context of Sino-US geopolitical tensions. Such an approach would be akin to 'an eye for an eye' manifested as 'a dollar for a dollar' strategy. Should oil-producing countries invest in China's dollar bonds instead of recycling their revenues into US Treasuries, China would effectively be bidding dollars away from the US in the global market, thus hitting the US by inflicting funding pressure on its twin deficits.

While the US Federal Reserve (Fed) could still print more dollars, China would increasingly influence where those dollars would flow. The dollar-for-dollar strategy could potentially weaken the dollar's network effect – when everyone uses it, then everyone else uses it – and increase the renminbi's global impact at the expense of the dollar's hegemony in the medium-term.

ENTER THE BELT & ROAD INITIATIVE

One may wonder what is the point of China issuing dollar bonds and adding to the huge pile of dollars that it has amassed through its current account surplus? Subtly, such dollar bond issuance lays bare China's motive for accumulating USD to advance its RMB internationalisation programme through the BRI.

Out of the 195 countries in the world, 150 are part of the BRI. And many of these owe dollar-denominated debts to the US government or other developed world lenders. China could use its USD to help the BRI countries pay off their dollar debts to the developed world and arrange for them to repay China in renminbi, or through other bilateral arrangements such as strategic resources.

This would be a 'one-stone-kills-three-birds' move that would allow China to 1) use its excess dollars 2) to help its partner countries reduce their USD risk exposure and 3) deepen its integration with BRI countries, and, by corollary, alienate them from the US. China's help would make strategic sense for the BRI countries also as it could help them escape the dollar debt trap, reduce their dollar risk exposure (including that of US sanctions), and improve relations with the main country helping their development: China.

GEOPOLITICAL IMPLICATIONS

China's sovereign dollar bond issuance programme in effect makes it an intermediary at the heart of the dollar system. While the dollars still make their way back to the US through the US government borrowing to fund its twin deficits, there is now an alternative route to flow back to the US through China's borrowing. This alternative builds Chinese rather than American influence in the global system and undermine the US's ability to finance itself.

How might the US respond?

One response would be to threaten sanctions against countries or institutions that buy China's sovereign dollar bonds. Indeed, there are signs of the US doing so. On 30 November 2024, US President-elect Donald Trump wrote on his social media platform, Truth Social, demanding that BRICS member countries commit to not creating a new currency or supporting another currency that would replace the dollar or face 100% tariffs.

However, such scare tactics would further show that dollar assets are not safe from US political interference and, thus, could encourage countries to diversify out of the dollar, further eroding its network effect. This can already be seen as an after-effect of US sanctions against Russia, which created some impetus for countries to move out of the dollar together.

Another option would be for the US Fed to raise interest rates to attract demand for US Treasuries. However, China could easily match that and nullify the impact. Crucially, raising rates by the Fed for this reason would be self-defeating. This is because it would increase the US government's borrowing costs when it is already struggling with financing the massive twin deficits, potentially creating an economic recession.

On the contrary, were China to pay higher interest rates to attract demand for its sovereign dollar bonds, it could dry up demand for US Treasuries. This could force the US to respond by also raising rates, which would disrupt its financial and economic systems.

The US could go for the 'nuclear option' of shutting China out of all USD transactions. However, this would hurt the US at least as much as China due to the complicated crisscrossing relations between China, the US, and the world. It would effectively fragment the global financial and trade system, undermining the dollar's role as the global reserve currency – an outcome the US is trying to avoid.

SO?

The creeping influence of the RMB can be seen to be building the foundation for making Chinese assets a standalone asset class in the long-term, rather than part of the emerging market asset class.

The rise of China as a manager of dollar liquidity could influence the future demand for US Treasuries and US interest rate levels. There is little the US can do to avoid its global influence being eroded in some shape or form.

Geopolitical tensions and strategic competition between the two big powers will continue for the foreseeable future. On a positive note, thinking about all this in the Game Theory framework, if China's strategy is to force the US to contemplate every possible uncomfortable outcome, the drive for both players to reach a 'Nash equilibrium' (where a player will stick with their chosen strategy and have no incentive to deviate from it, after considering the opponent's best strategy) could lead to constructive competition in the future. That might mean that the unpleasant implications financial markets have priced in so far may not materialise.

The US will just have to come to terms with the reality of living alongside China.

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