FOR WHOLESALE INVESTORS ONLY – 10 March 2022

Chi on China

THE GREAT INSTABILITY OF DIGITAL DISRUPTION (IV): BREAKING UP THE GLOBAL PAYMENTS SYSTEM

Do what you say you're going to do. And try to do it a little better than you said you would.

Jimmy Dean

SUMMARY

- Cooperation between China and other countries to establish alternative international payment systems to the US dollar-denominated SWIFT system could increase the world's incentive to reduce the global dominance of SWIFT, leading to a breakup of the global US dollar-centric system.
- The digital renminbi could facilitate a switch to using China's cross-border payments system. With enough penetration of the digital renminbi in a separate jurisdiction or region, a trade and finance system parallel to the US dollar system could gain critical mass.
- In the long run, the breakup of the global payments system will facilitate the expansion of the digital renminbi's international role and, thus, challenge the currency hegemony of the US dollar, disrupting to the global financial system and regulatory regime in the process.

Since the change in US foreign policy towards China from pre-Trump constructive engagement to strategic competition since 2017, a global notion has emerged whereby China seeks to decouple from the US, disrupting the global economic system. The Russia-Ukraine crisis has intensified this decoupling concern as it is pushing Russia to work closer with China; both countries share the common interest of counteracting the influence of the US.

NO DECOUPLING EVIDENCE YET

China does not have a decoupling policy. This is evident from its 'dual circulation policy, which came into effect in early 2020.[1] Its aim is to strengthen the domestic sector as the main driver of growth while still engaging, but reducing reliance on, the external sector to sustain stable growth and resilient investment.

On the economic front, China continues to receive net Foreign Direct Investment inflows, including from the US, despite rising geopolitical tensions since 2018 when the Sino-US trade war started. This does not signal economic decoupling.[2]

Evidence shows that, despite the trade war and the pandemic, Sino-US bilateral trade has continued to rise (Exhibit 1), defying expectations.[3] Foreign firms have repatriated profits rather than capital, implying that they are not leaving China.

Despite all the political and market noise, the US seems to be integrating further into China's financial sector rather than decoupling from it. Formerly, foreign financial firms in China were only allowed to operate joint ventures with minority ownership stakes. However, market liberalisation since 2019 has led to a sharp increase in the number of majority or wholly foreign-owned financial institutions operating in China. They include many large US firms such as PayPal, Goldman Sachs, JP Morgan, American Express, Fitch Ratings and S&P Global.[4] Meanwhile, China's integration into the global financial markets has also deepened as it opens up the onshore capital market to foreign investors.

A DIFFERENT STORY

The global payments system may be a different story when considering the possibility of disruption arising from decoupling. Dollar dominance is not just about what currency to use, but also about the clearing and payments systems. In recent years, from China to Europe and the Middle East there is a growing incentive to diversify US dollar risk exposure by shifting away from the US dollar-based payments system, the Society for Worldwide Interbank Financial Telecommunication (SWIFT). Examples include:

- In 2014, Russia introduced its System for Transfer of Financial Messages (SPFS)
- In 2015, China set up its Cross-Border Inter-Bank Payments System (CIPS)
- In 2020, the EU developed the European Payments Initiative (EPI)
- In early 2021, an affiliate of the People's Bank of China (PBoC), the Digital Currency Institute, launched the Multiple Central Bank Digital Currency Bridge Project (or m-CBDC Bridge project) in tandem with the Hong Kong Monetary Authority, the Bank of Thailand and the Central Bank of the United Arab Emirates. This involves a central bank digital currency (CBDC) project for cross-border payments endorsed by the Bank for International Settlements Innovation Hub Centre in Hong Kong.

All these systems are built to compete with or bypass the USD-based system. China is at the forefront of this, having leapfrogging the developed world in the Fintech race since the early 2000s.[5] The creation of China's official digital currency, the Digital Currency Electronic Payment (DCEP), in 2019 has consolidated its digital revolution. If China's

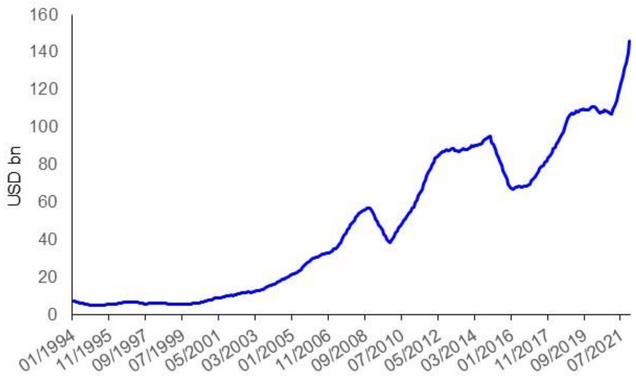
Note: All tables are as at March 2022, unless otherwise stated

digitalisation enables other countries to engage in international transactions using DCEP, they would be escaping the ambit of US influence, which would inevitably erode its global control.
China's CBDC would also make international lending and aid provision faster, more transparent and traceable. When the recipient countries use DCEP to settle trade or infrastructure investments contracted by China, the US dollar and related technology will be replaced in those markets.

If China were to work with Russia, it could strength its international payments system, CIPS. Arguably, this is the key area where China may decouple from the US by breaking up the current US-centric international payments system. However, complete decoupling is still not going to happen, in my view, because as long as China still engages with the external sector and foreign capital, as stipulated by the dual circulation policy, it will remain part of the USD-based payments system. In the future, a multi-polar world of cross-border payments systems may emerge.

There was strong economic interest in China and Russia working together even before this crisis. Russia's Eurasia Economic Union (EAEU) overlaps China's Belt & Road Initiative route in Central Asia and Eastern Europe. Reflecting the growing economic relationship is the rise in Sino-Russian trade (Exhibit 2), and the fact that Russia has reduced the dollar share of its foreign exchange reserves to about 16% while increasing the renminbi's share to 14%. Some of Russia's other foreign currency assets and gold are also held in China.[6]

Exhibit 2: China's total trade with Russia*



* 12-month rolling sum   sources: CEIC, BN Paribas Asset Management Mar 2022

The current geopolitical tensions could cement the working relationship between Russia's SPFS and China's CIPS. The long-term impact would likely be far-reaching, and beneficial for China but negative for the US. This is because Russia is the second largest exporter of energy and China is the largest manufacture exporter. Sino-Russian bilateral trade and countries which want to deal with Russia and China could switch to use the SPFS or the CIPS and non-USD currencies to settle transactions.

Meanwhile, China has been active in promoting the usage of the renminbi for oil trades since 2018. It has set up its own oil futures exchange with contracts denominated in renminbi. It has also sought to persuade Middle Eastern oil-producers to settle oil trade with China in renminbi (with Chinese payments backed by gold in China). If Russia were to work closer with China – bearing in mind that Russia is a major oil exporter and China is the world's largest oil importer – the amount of oil trade between them settled in renminbi through CIPS could rise sharply at the expense of USD and SWIFT.

DISRUPTING TECHNOLOGY AND INTERNET

If there is enough penetration and acceptance of the digital renminbi in a separate jurisdiction or region, it is conceivable that a trade and finance system parallel to the US dollar-system can gain critical mass. In setting up CIPS, pushing the digital revolution, creating DCEP, implementing the digital BRI and launching the m-CBDC Bridge project, it is clear that China is aiming at building a renminbi bloc of finance, trade, investment and technology with – but not limited to – the developing world

While no one expects the dollar to lose its global currency status any time soon, its longer-term hegemony could be challenged by the digital renminbi catalysing revolutionary changes in global finance, disrupting the prevailing system. The Russia-Ukraine crisis may just facilitate this disruption process.

A new world of digital finance with CBDC supporting alternative international payments systems might also lead to an internet bifurcation into a Chinese-led system and a non-Chinese internet led by the US[7]. This would have far-reaching implications. China's effort to promote the digital Belt and Road Initiative helps recipient countries to better manage their digital communications networks, including data management, filtering and content surveillance. This could create regulatory systems with different tech-management policies adopted by those countries that use the Chinese system and those that do not.

Granted, China's CBDC is not a silver bullet solution to its structural economic problems, notably a distorted financial system with an under-developed financial market. Ultimately, China needs to establish the renminbi's global credibility to gain acceptance, be it in digital or physical form. However, it appears that China's disruption to the future global payments system is likely an emerging reality even before the renminbi becomes a global currency.

REFERENCES

[1] See "*Chi on China: China's Dual Circulation Strategic Pivot to Counter External Exigencies and Global Demand Shift*", 16 September 2020.

[2] See "*Chi on China: Decoupling From China Easier Said Than Done*", 22 July 2020.

[3] See "*Chi Time: What Decoupling From China? A New Thesis From Asia's Supply-Chain Shift*", 19 August 2021.

[4] See also Lardy, Nicholas and Tianlei Huang (2020). "*Despite the Rhetoric, US-China Financial Decoupling Is Not Happening*", China Economic Watch, Peterson Institute for International Economics. July 2.

[5] See Chorzempa, M. (2018). "*How China Leapfrogged Ahead of the United States in the Fintech Race*", Peterson Institute for International Economics, China Economic Watch, April 26.

[6] See Abay, Emre G. (2022). "*Around 35% of Russia's Accessible Assets are in Country, China*", Anadolu Agency, 1 March. https://www.aa.com.tr/en/asia-pacific/around-35-of-russias-accessible-reserves-in-country-china/2519923

[7] Chin, J. (2019). "*The Internet, Divided Between the U.S. and China, Has Become a Battleground*", The Wall Street Journal, February 9. https://www.wsj.com/articles/the-internet-divided-between-the-u-s-and-china-has-become-a-battleground-11549688420

Chi Lo, Senior Market Strategist
BNPP AM APAC

Note: All tables are as at March 2022, unless otherwise stated

DISCLAIMER

This material is issued and has been prepared by BNP PARIBAS ASSET MANAGEMENT Asia Limited (the "Company"), with its registered office at 17/F, Lincoln House, Taikoo Place, Quarry Bay, Hong Kong. BNP PARIBAS ASSET MANAGEMENT Asia Limited in Australia is an authorised representative of BNP PARIBAS ASSET MANAGEMENT Australia Limited ABN 78 008 576 449, AFSL 223418 ("BNPP AMAU"). This material is distributed in Australia by BNPP AMAU. This material has not been reviewed by the Hong Kong Securities and Futures Commission. This material is produced for information purposes for wholesale investors only and does not constitute:

1. an offer to buy nor a solicitation to sell, nor shall it form the basis of or be relied upon in connection with any contract or commitment whatsoever or

2. investment advice.

This material makes reference to certain financial instruments authorised and regulated in their jurisdiction(s) of incorporation.

No action has been taken which would permit the public offering of the financial instrument(s) in any other jurisdiction, except as indicated in the most recent prospectus, offering document or any other information material, as applicable of the relevant financial instrument(s) where such action would be required, in particular, in the United States, to US persons (as such term is defined in Regulation S of the United States Securities Act of 1933). Prior to any subscription in a country in which such financial instrument(s) is/are registered, investors should verify any legal constraints or restrictions there may be in connection with the subscription, purchase, possession or sale of the financial instrument(s).

Investors considering subscribing to the financial instrument(s) should read carefully the most recent prospectus, offering document or other information material for further details including the risk factors and consult the financial instrument(s') most recent financial reports. These documents are available from your local BNPP AM correspondents, if any, or from the entities marketing the Financial Instrument(s).

Opinions included in this material constitute the judgement of the Company at the time specified and may be subject to change without notice. The Company is not obliged to update or alter the information or opinions contained within this material. Investors should consult their own legal and tax advisors in respect of legal, accounting, domicile and tax advice prior to investing in the financial instrument(s) in order to make an independent determination of the suitability and consequences of an investment therein, if permitted. Please note that different types of investments, if contained within this material, involve varying degrees of risk and there can be no assurance that any specific investment may either be suitable, appropriate or profitable for an investor's investment portfolio.

Investments involve risks. Given the economic and market risks, there can be no assurance that the financial instrument(s) will achieve its/their investment objectives. Returns may be affected by, amongst other things, investment strategies or objectives of the financial instrument(s) and material market and economic conditions, including interest rates, market terms and general market conditions. The different strategies applied to financial instruments may have a significant effect on the results presented in this material. Past performance is not a guide to future performance and the value of the investments in financial instrument(s) may go down as well as up. Investors may not get back the amount they originally invested.

The performance data, as applicable, reflected in this material, do not take into account the commissions, costs incurred on the issue and redemption and taxes.

All information referred to in the present document is available on www.bnpparibas-am.com

Note: All tables are as at March 2022, unless otherwise stated