



Chinese outwards mercantilism – The art and practice of bundling[☆]



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ABSTRACT

The Global Financial Crisis (GFC) brought to the fore the limits of the Chinese export led-growth strategy and the need for Chinese rebalancing of its international business approaches. Our paper takes stock of what may be the new chapter of Chinese outward-mercantilism, which aims at securing a higher rate of returns on its net foreign asset position, leveraging its success in manufacturing exports, natural resource imports and RMB internationalization. Using micro-level project data and macroeconomic covariates, we find positive association of Chinese trade and financial flows with China's outward direct investment (ODI). The relationship is stronger for ODI originated from the Chinese state-owned enterprises, and strengthened by the provision of RMB swap-line agreements with China's trading partners. The evidences support the conjecture that Chinese ODI is bundled to trade and financial linkages with its investment and trading partners.

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1. Introduction

China has been a prime example of export-led growth that has benefited from learning by doing, and by adopting foreign know-how, supported by a complex industrial policy. Arguably, a modern version of mercantilism has been at work (Aizenman and Lee, 2008). The rapid growth, growing trade, and current account/GDP surpluses in the 2000s had occurred in tandem with massive hoarding of international reserves (IR) combined with massive sterilization of expanding trade surpluses and financial inflows.¹ These policies were aimed at delaying and slowing the real appreciation associated with successful rapid growth. Following the Asian crisis of 1997–98, which mitigated Chinese competitiveness in the late 1990s, as well as Chinese accession to the World Trade Organization (WTO) in the early 2000s, the country intensified its drive toward export-led growth, racking up current-account surpluses and growing stockpiles of international reserves. On the eve of the financial crisis,

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¹ We note that international-reserves accumulation may be the outcome of current account surplus in countries with inferior financial intermediation, and not only mercantilism (Ju and Wei, 2010). Yet, running current account surplus does not imply hoarding mostly international reserves, as it may be consistent also with outward FDI, like what has been done by Japan, even if its financial intermediation is inferior to that of other countries. The timing of moving towards Chinese outward FDI around the global financial crisis is consistent with our interpretation.

China's real GDP growth had reached 14%, its current-account surplus had grown to 10% of GDP, and its international reserves had reached about 50% in 2010 (Aizenman et al., 2014).

The global financial crisis (GFC) of the late 2000 s put an abrupt end to the Chinese export-led, growth-cum-large current-account surplus trajectory. In the U.S., the private sector was forced to de-leverage and lower demands for imports. Other crisis-hit developed countries also cut back on imports. Consequently, the GFC and its aftermath induced rapid Chinese internal balancing, reducing the scope of future reserve hoarding. Since the crisis, China's current-account surplus fell from 10% of GDP (2007) to about 2% in 2013. A legacy cost of Chinese policies during the 2000s has been its skewed external balance—long on low-yielding foreign assets (mostly international reserves), and short on high-yielding assets (mostly large liabilities associated with past net FDI inflows to China). While China's net external financial assets in 2013 was about 20% of China's GDP, the real net return on these assets was negative.² This reflects two fundamental factors – the low real return on Chinese international reserves (two-third of its gross external assets), and the high return on past FDI inflows to China, which accounts for about 60% of Chinese external liabilities.³ The low return on Chinese foreign assets is bad news, especially considering the rapid aging of China's population. This is in contrast to Japan, where the sizable return on Japan's foreign asset position helps in buffering the future income of its rapidly graying population.

A way of mitigating the adverse consequences of Chinese legacy external balance sheet exposure is external rebalancing, that is “swapping” overtime some of its international reserves with higher yielding foreign equities and Chinese outward direct investment (ODI). Indeed, China embarked on diversifying its holdings of dollar IR by channeling surpluses into a sovereign wealth fund (SWF), encouraging outward foreign direct investment in tangible assets, and offering much higher expected returns.⁴ The outcome has been growing ODI in the global resource sectors and infrastructure services, especially in commodity and mineral exporting countries, which includes developing countries and emerging markets in Africa and Latin America. In a way, China has joined the trend of other Emerging Markets (EMs).⁵

After the GFC, China embarked on large bilateral currency-swap agreements with other countries. This was done in tandem with the unprecedented provisions of swap lines among the Organization for Economic Co-operation and Development (OECD) countries and the more selective provision of four swap lines by the U.S. Federal Reserve (FED) to selected emerging market economies (Appendix Table 2). Comparing the bilateral swap lines offered by the U.S. FED and the People's Bank of China (PBOC) reveals key differences. Most of the swap lines offered by China have been to commodity countries, developing and emerging market economies, whereas most of the bilateral swap lines offered by the U.S. FED are between the OECD countries, and four emerging markets: Brazil, South Korea, Mexico, and Singapore. Aizenman and Pasricha (2010) pointed out that the selection criteria explaining the U.S. FED supply of bilateral swap lines to emerging markets were close financial and trade ties, a high degree of financial openness, and a relatively good sovereign credit history. Chances are that similar factors account for the Chinese supply of Renminbi (RMB) bilateral swap lines to a growing list of developing and emerging markets, as has been illustrated by Garcia-Herrero and Xia (2015).⁶ This strategy blends very well with the trade internationalization of the RMB in the context of the broader outward investment strategy of China, and is consistent with the channeling of China's net foreign-asset position into an ODI-cum-credit strategy.

Against this background, our paper takes stock of what may be the new chapter of Chinese outward mercantilism, which is aimed at securing a higher rate of returns on its net foreign asset position, leveraging its success in international trade, and its large net foreign asset position. We conjecture that in the aftermath of the GFC, China has bundled ODI with its finance dealing (lending, swap lines, trade credit), its trade and foreign investment (including exports of Chinese capital products and labor services), and leveraging its growing market clout. This bundling strategy has been mostly applied to developing and emerging market economies, and to “commodity-countries”. During the GFC and its aftermath, China increased rapidly its ODI, swap-lines, imports and exports in tandem to the selected countries. Such a bundling strategy is consistent with Adams and Yellen (1976): bundling as a manifestation of market clout in which the bundling party leverages its market powers aimed at increasing its surplus. Accordingly, China may use its market power in the provision of “swap and lender of last resort”, supplying capital goods, and infrastructure services to its trading partners.⁷

Throughout the history of corporations and countries, Bundling has been a common practice to market a group of products/services as a package. Bundling's welfare implications are ambiguous, as it may be used to reduce cost and improve quality, and for price discrimination (Nalebuff, 2008). Bundling strategy is important for multinational enterprises (MNEs) to enter foreign markets. It has been widely studied in industrial organization and marketing (Adams and Yellen, 1976,

² See <http://rhg.com/notes/chinas-international-investment-position-2014-update.2>.

³ According to the State Administration of Foreign Exchange (SAFE), China's external financial assets were about U.S.\$ 6 trillion at the end of 2013, of which international reserves were about two-third (U.S. \$3.9 trillion), the outbound direct investment about 10%, securities investment about 4%, and other investment at about 20%. The country's external liability position was 4 trillion U.S.\$, out of which FDI in China was \$2.35 trillion, 60% of the total liability. The investment in securities and other aspects took up 10% and 30%, respectively.

⁴ On December 19, 2013, the WSJ reported “Beijing will ease the approval process for all but the largest Chinese investments in overseas companies and projects, a major relaxation of regulatory oversight that analysts say is aimed at encouraging Chinese firms to expand abroad.”

⁵ Aizenman and Pasricha (2013) noted that EMs eased outflows of capital more in response to higher stock price appreciation, higher appreciation pressures in the exchange market, higher IR/GDP, and higher real exchange rate volatility.

⁶ Garcia-Herrero and Xia (2015) concluded the choice of countries signing an RMB-denominated bilateral swap agreement with China was predominantly by “gravity motifs”; that is, by country size and distance from China, as well the trade motif in terms of both exports to China and the existence of the Free Trade Agreement (FTA) with China. Institutional soundness also matters, since countries with better government and less corruption are more likely to sign an RMB-denominated bilateral swap agreement.

⁷ Such a bundling strategy may also act as a barrier to entry of late new comers in the destination countries (Nalebuff, 2004).

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