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INTRODUCTION

China's Global Interdependence: International Reserves, Capital Inflows, Financial Market Transmission, and Exchange Rate Determination

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"Quand la Chine s'eveillera, le monde tremblera …"

["When China rises, the world will tremble …"]

(Napoleon Bonaparte)[1]

"There is a huge prize here that Xi Jinping is focused on: China eventually eclipsing the US as the global financial hegemon"

(Jan Dehn, Ashmore Group Head of Research)[2]

EDITORS' INTRODUCTION

One of the most dramatic and important developments in recent decades has been China's expanding international presence since economic reforms began in 1978. Initially China made its mark primarily through rapid export growth and expansion in the domestic real economy. However, financial market liberalization and gradual relaxation of capital controls

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have added to the global role of China's currency— the renminbi—and fueled increasing interconnections not only within Asia but also with the Western economies and the emerging economies of Africa and Latin America. China's ambitious "One Belt, One Road" (一帶一路) initiative spans over 68 countries and encompasses nearly four and a half billion people, in aggregate accounting for close to 40% of global GDP. These developments have been accompanied by a rapidly growing and increasingly important offshore renminbi bond market (Fung, Ko, Ling, & Yau, 2016) and the renminbi has been among the top ten of all world currencies by trading volume since 2013. Major steps in monetary and financial liberalization include the removal of the fixed exchange rate with the U.S. dollar in 2005 (Burdekin, 2008), the establishment of the offshore market for the renminbi in Hong Kong in 2010 (Burdekin & Tao, 2017), the Shanghai-Hong Kong Stock Connect of November 2014 (Burdekin & Siklos, 2018), and the Shanghai-London Stock Connect planned for 2019 (Burdekin & Tao, 2018). Although no formal link-up with the U.S. market is in hand, Chinese shares have become increasingly widely traded on the New York Stock Exchange (NYSE)—with the Shanghai Stock Exchange itself ranking only behind the NYSE and Nasdaq in terms of average monthly trading volume in 2018.

China's rise has not come without its full share of controversy, however, both at home and abroad. Domestically, there have been considerable nervousness about the huge fluctuations in the stock market and the increased indebtedness of firms and local governments. Internationally, one oft-repeated charge in U.S. policy circles has been whether China has manipulated the external value of its currency by keeping it artificially low against the U.S. dollar even after the 2005 change in exchange rate policy. This concern has been fueled not just by the growth of Chinese exports to the United States but also the nation's rapid accumulation of international reserves. In this regard, Ouyang, Rajan and Willett (2010) conclude that China had been operating as a "reserve sink," absorbing the international reserves of other countries in a manner akin to Germany and Japan during the latter stages of the Bretton Woods fixed exchange rate system. Before its recent decline the RMB had appreciated substantially, its trade surplus had shrunk, and its reserve holdings had fallen. Thus, the case that China was using its exchange rate policy to promote its exports in a beggar-thy-neighbor fashion has substantially weakened if not disappeared altogether. There has been a continued large surplus with the United States, however, which has led the Trump administration to impose trade sanctions against China, very unwisely in our judgment. Admittedly, outstanding questions surround the level of foreign access to the Chinese market, whether unfair restrictions have been placed upon foreign-owned operations and foreign direct investment (FDI) in China, and the level of protection of international property. Nevertheless, China accounted for approximately 20% of total developing country FDI inflows in 2016—while representing an even more striking near 50% share of total developing country FDI outflows (Ju & Yu, 2018).

The four articles in this special issue all examine the development of key aspects of China's increasingly important role in the global economy. These contributions extend across monetary and financial interdependence and bear on the controversies surrounding China's exchange rate determination, reserve build up, and levels of FDI. The up-to-date sample periods utilized in the empirical work shed light on major changes occurring in these areas in the aftermath of the global financial crisis.

The first article on "International Capital Flows and the Independence of China's Monetary Policy," by Yanzhen Wang, Thomas D. Willett and Xiumin Li, examines the quantitative relationship between international capital flows and China's monetary policy using monthly data from January 2000 through December 2017. The authors identify an important role for reserve requirement changes over their sample period, finding that failure to take such changes into account produces erroneously low estimates of both the degree of sterilization (the ability of central banks to keep payments imbalances from having substantial influences on the domestic money supply) and the extent of capital mobility as measured by the offset coefficients. Their results imply that despite considerable liberalization of the capital account the People's Bank monetary policy is able to almost completely sterilize monetary base fluctuations caused by international capital flows. This represents an important exception to the widely-held presumption that limiting exchange rate flexibility causes the loss of most monetary independence. The People's Bank's ability to sterilize shows that the famous international monetary policy trilemma, namely that a country cannot have substantial capital mobility, pegged exchange rates, and monetary policy autonomy at the same time, need not hold in the short run. Rather it is a set of longer-run constraints. The ability of countries to sterilize is widespread. For example it has also been seen in Europe in the past (Laney & Willett, 1982) and in many other emerging markets today (Ouyang, Rajan & Willett, 2008). The present results imply that despite considerable liberalization, China's capital controls, combined with inherently less than fully developed domestic financial markets, continue to allow considerable freedom for Chinese monetary policy to counter domestic and international shocks.

The second article on "Roads to Prosperity? Determinants of FDI in China and ASEAN," by Sasidaran Gopalan, Ramkishen S. Rajan, and Luu Nguyen Trieu Duong, assesses the factors influencing "Greenfield" FDI inflows into China and the economies of the ASEAN group. Such Greenfield inflows involve "brick and mortar" physical investments as opposed to other types of inflows that may merely involve a transfer of ownership over existing assets. The authors focus on the degree to which physical infrastructure matters in terms of attracting Greenfield FDI inflows and employ panel data estimation over the 1995–2016 period. The length of paved roads and the numbers of fixed telephones and mobile subscriptions (per 100 subscribers) are used to represent the extent of infrastructure development in each country. After controlling for institutional factors such as the rule of law, and political stability as well as an array of macroeconomic variables, the article's results reveal a positive relationship between the infrastructure variables, especially roads, and Greenfield FDI inflows that is both statistically and economically significant. The particular importance of roads is very much in keeping with China's "One Belt, One Road" drive to facilitate greater connectivity between Asia and the rest of the world.

The third article on "Macroeconomic Drivers of Chinese ADRs: Home Country vs. U.S. Effects," by Richard C. K. Burdekin and Junjie Zhang, examines the relative importance of both home-country and U.S. macroeconomic variables for Chinese ADRs traded on the New York Stock Exchange as well as for a closed-end fund that invests directly in the Shanghai market but trades in New York. The authors allow for changing effects of the macroeconomic variables over time using a Markov-switching approach to incorporate potential shifts in behavior in times of panic, such as the period following the onset of the 2008 global financial crisis. Both the Chinese ADRs and the closed-end fund generally react more to the U.S.

macroeconomic variables than the Chinese variables and home-country economic effects turn out to be quite limited over the 2007–2017 sample taken as a whole. The reactions to both sets of macroeconomic variables vary significantly over the crisis and post-crisis episodes, however, pointing to the importance of allowing for behavioral shifts over relatively short sample periods.

The fourth article on "The Changing Sources of Real Exchange Rate Fluctuations in China, 1995–2017: Twinning the Western Industrial Economies?," by Yuan Tian and Eric J. Pentecost, demonstrates a shift in the influences on China's real exchange rate fluctuations over the 1995–2017 period. It shows that the changing mix of these influences over time implies that China now fits more the case for advanced economies than for developing ones. Whereas the effects of relative real demand shocks are in keeping with the pattern observed elsewhere, supply shocks also exerted large and highly significant exchange rate effects for China prior to 2005. China's move toward a more flexible exchange rate after 2005 made nominal shocks a more important source of real exchange rate variability, however. Impulse response and variance decomposition analysis suggest that, although real relative demand shocks remain the main source of real exchange rate fluctuations in China, nominal shocks have become much more important not only in absolute terms but also relative to supply shocks. This suggests that, following the abandonment of the pre-2005 strict fixed exchange rate regime, the sources of China's real exchange rate fluctuations have become more similar to those of developed industrial countries.

We believe that these four articles will provide the reader with useful insights into China's rapidly expanding role within the global economy.

NOTES

1. Quote attributed by Peyrefitte (1977).
2. Quoted in Capon (2018).

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