JK Capital Management Ltd.

Week of 21st December 2020

What's on our mind this week?

China and the EU close to a landmark deal

Last week China and the EU were reported to be close to reaching an agreement on a landmark investment deal. The bilateral investment deal, known as the Comprehensive Agreement on Investment, was set in motion in 2019 with a self-imposed deadline to reach an agreement before the end of 2020.

The agreement would increase market access for European companies by setting sector-by-sector commitments to remove or reduce barriers such as joint venture requirements and investment bans. Sectors set to be covered by the deal include manufacturing, financial services, real estate, construction and auxiliary services to support shipping and air transport. On the other side, China would get guaranteed rights to invest in parts of the EU economy, notably the energy sector, including renewables. Sustainable development is a key topic being discussed, displaying the commitment of all parties to it.

The agreement would be an extension of China's policy of opening up its economy and reinforcing its commitment to free trade. Chinese companies have often shown their will to invest in European countries (such as Huawei which just announced that it had chosen the town of Brumath in France, next to Strasbourg, to build a factory dedicated to manufacturing products for the European market). This agreement would help them considerably. Bilateral trade between the blocs exceeded USD 650bn last year. The new agreement aims to build on this relationship.

Beyond the business aspect, the agreement would also be a diplomatic win for China. After a Trump presidency that damaged China's relationship with most Western economies and before the Biden administration starts rebuilding the Atlantic alliances with a view to have increased leverage over the Asian giant, China may just manage to squeeze a last-minute agreement with the EU enshrining rules for freer bilateral investments. Such a tour de force would be remarkable, even more so than the pan-Asian deal agreement reached in November (see article here). This is probably why the Chinese president Xi Jinping made repeated public commitments to striking a deal, an unusual thing to do for a head of State.

Beyond the tight year-end deadline, one item may still derail the deal. The EU is making a strong push for China to commit to honouring international agreements on labour rights. EU officials say Beijing's refusal to ratify the International Labour Organisation (ILO) standards on forced labour will make it politically difficult for the European Parliament to vote in favour of the agreement. This demand is directly related to the ongoing situation in the Chinese province of Xinjiang.

Earlier this year the free trade agreement between EU and Vietnam came into force. It included several fundamental conventions of the ILO, including those on freedom of association, the right to collective bargaining, ending forced labour and child labour. Would the EU be able to obtain such concessions from China? Probably not. Nevertheless, the tight deadline and the looming resurrection of a strong Atlantic block may push China to compromise, in which case an agreement may be quickly reached.

China, the first country in the world to roll out its digital currency

Inspired by Bitcoin that was invented in 2008, central banks around the world have been working on the development of their own digital currencies (Central Bank Digital Currency or CBDC, also called digital fiat currency or digital base money).

CBDC, which by definition does not have any physical format, is a revolutionary concept that could ultimately replace fiat money (or paper money) which appeared centuries ago. CBDC is different from virtual currencies and cryptocurrencies that are not issued by central banks. Cryptocurrencies use blockchain technology, they lack legal tender status and they are finite in nature (e.g. there will never be more than 21 million bitcoins, rain or shine). CBDCs are the opposite of cryptocurrencies in these respects as they remain under the tight control of central banks which can issue as many as they want. From that perspective CBDCs do not offer any hedge against inflation risk or devaluation risk, as opposed to cryptocurrencies. Paying through CBDCs is not anonymous either, contrary to cryptocurrencies that have become the preferred method of payment of arms and drug dealers doing business on the dark web. Still at a development stage, 8 central banks out of 10 are known to be working on their own CBDC.

China invented paper money, the current format of fiat money, as early as in the 7th century. Coincidence or not, China is again ahead of all other countries as it became the first one to introduce its sovereign digital currency, i.e. a digital Yuan which is referred to as the Digital Currency Electronic Payment (DCEP).

China had already been the first country in the world to widely adopt mobile digital payment systems. These systems were developed by internet giants Alibaba with Alipay and Tencent with TenPay. With explosive growth starting from 2013, these two payment systems have trained more than a billion consumers on how to use their mobile phones for daily payments. TenPay and Alipay have replaced coins, notes and credit cards in China to the point that many shops, street vendors and taxi drivers no longer accept cash. First time visitors to China are always fascinated by the fact that anyone can live his or her daily life without carrying anything other than a mobile phone.

DCEP will soon be another app on their mobile phones. One difference from the consumer's perspective between the digital Yuan and TenPay/Alipay is that it uses Near Field Communication technology as opposed to QR codes. It does not require online connectivity to complete a transaction, bringing more convenience to consumers and shopkeepers.

China's central bank, People's Bank of China (PBoC) started its research on digital Yuan as early as 2014. In recent months activity picked up as it completed the infrastructure needed for DCEP. It carried out live tests in September in Shenzhen, Suzhou, Xiong-An, and Chengdu and it is now rolling it out on major e-commerce platforms throughout the country. JD.com became last week the first e-commerce platform to adopt this new payment system. The Chinese government plans to use the 2022 Winter Olympic Games in Beijing to showcase the technology to an international audience.

Since China already revolutionised digital payments with TenPay and Alipay, one could wonder why it needs a digital Yuan. The answer is three-fold:

Even though the digital Yuan is directly managed by PBoC, it needs commercial banks to act as distributors and payment intermediaries. Both commercial banks and PBoC are requested to keep databases that track the flows of digital Yuan from user to user. We understand that for the time being there is no plan to replace M0 (notes and coins), but one can easily imagine that this could happen in a not-so-distant future. The advantage for PBoC and for the Chinese government would be to always know how much cash anyone has and details of all transactions.

The second advantage would be to break the duopoly of Tencent and Ant Group, the two companies that control TenPay and Alipay. It was only a few weeks ago that the IPO of Ant Group got derailed by the Chinese government because of the systemic risk Ant Group was representing due to its size, to its open ambitions and to a lack of regulations to supervise it. Since then we have seen the Chinese government taking actions against monopolies in the internet and e-commerce space, triggering a de-rating of the entire sector. The Chinese government is not interested in replacing TenPay and Alipay that have become ubiquitous, but we believe it has a vested interest in competing with them by introducing an alternative payment system.

The third advantage is to speed up the internationalisation of the Yuan. Once the Yuan is digitalised, merchants have downloaded the app and foreign banks have adopted the platform, it would become as easy to pay for an ice-cream at the Eiffel Tower in Yuan with a mobile phone as it is in Euro with coins.

These motivations are certainly very different from those of other central banks around the world that are currently developing their own digital currencies. For them, holding notes and coins in wallets is just a costly, cumbersome and antiquated mode of holding cash in this day and age.