China to the rescue?

Branko Milanovic

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Who could soften the apocalyptic effects of the war in Ukraine on the global south? China could, says Branko Milanovic.

State capitalism—China has more than a trillion dollars worth of US treasuries (William Potter / shutterstock.com)

The war between Russia and Ukraine, which has already lasted more than a hundred days with no end in sight, has been nothing short of disastrous. It has resulted in thousands (probably more than a hundred thousand) deaths and injuries, more than five million refugees, destruction of significant parts of Ukrainian territory and likely losses in gross domestic product of more than a third in Ukraine and around 10 per cent in Russia. It has exacerbated inflation in western Europe and the United States. Ideologically, it has led to a Tsarist-like revival of Russian nationalism and a return to a 1950s-style cold-war mentality in the west.

And the effects keep piling up, including rising food and energy prices. Ukraine, enjoying the almost limitless plains of the most fertile land in Europe, has long been a major exporter of wheat and corn. This role of international granary continued in the Soviet Union, although *kolkhozes* and *sovkhozes* (collective and state farms) impaired agricultural productivity. Russia is also a food exporter, and—as is well-known too—the third largest oil producer (after the US and Saudi Arabia) and the second largest of gas (after the US). Recent attempts to reduce western dependence on Russian gas and oil, and thus to throttle overall supply, have produced the spike in energy prices.

Severe shock

Despite the concerns often voiced, rich Europe can survive this coming winter without Russian energy and with higher food prices. In the worst-case scenario it will have to manage with several years of 'stagflation'—not a pleasant prospect, but not something to lead populations almost entirely among the 20 per cent of the richest people in the world to a state of despair.

The situation is different in the middle east, Africa and parts of Latin America. Food and energy importers there will be hit by a severe shock to their terms of trade: prices of imports will surge. Following the exhaustion of the population caused by the pandemic, this will further strain the patience of many. Moreover, the poor spend the largest proportion of their meagre incomes on food and energy. Surveys show that food and energy (including transport which is also heavily dependent on energy prices) account for around three-quarters of poor households' expenses. If the costs of cooking oil, bread, pasta, gas and bus and train rides increase, there will be little or nothing left to cover the rest of household needs.

What can importing countries do? As implied by those last two sentences, they can reduce subsidies or ask for foreign loans, mostly from the International Monetary Fund and the World Bank, which have promised to increase their lending. We shall thus have for the *n*th time a repeat of the history of the past 70 years: food riots and overthrown governments, and complaints about severe IMF loan conditionality. Is there a better way out?

Rich state

Enter China. While the Chinese population has become much better off thanks to the phenomenal economic growth of the past half-century, the Chinese state has became even richer. It holds more than one trillion dollars, the product of many years of trade surpluses, in US Treasury bonds.

The return on these bonds has been minimal for years, but China has had few other investment options. It faces the problem of any rich person or country: what to do with excess money? Domestically, it faces the absorption problem: using that money to finance, for example, new infrastructural projects would increase inflation. Externally, spending more on the Belt and Road initiative or infrastructure projects in Asia, the *raison d'être* of the two recent Chinese global banking initiatives, is unlikely to yield acceptable returns.

Could a part of these huge reserves held in the US be used to 'buy' foreign nations' goodwill and make a modest net return? Could China do well by doing good?

That possibility has recently received encouragement from an unlikely quarter. After the US seized Venezuelan, Afghan and then Russian central banks' assets, the probability of a similar measure being applied to China's assets in the US cannot be excluded. One can imagine multiple scenarios which would lead to such an outcome.
This in turn means that in calculating the expected return on China-held US assets, one must apply a non-zero probability to their total loss—a rate of return of minus 100 per cent. Let us assume that the actual risk of confiscation is 5 per cent and take the current bond yield rate of some 3 per cent. The expected return then becomes minus 2.15 per cent (-100×0.05% +3×0.95%).
Obviously, different probabilities of confiscation will yield different results—the negative return however holds for all probabilities above 3 per cent. The key point is that as long as

the probability of asset seizure is not zero, that eats into the normal (positive) returns Chinese assets can be anticipated to obtain in the US and drives the expected rate of return towards zero.

Special fund

The question then becomes: is it better for China to keep all its assets in the US or to take a portion of them—say one-tenth, which would still be a huge amount of $100 billion—and create a special fund to assist poor nations most affected by the increased prices of energy and food? Unlike IMF loans, Chinese loans could be disbursed without conditionality. They could be medium-term (perhaps repaid over eight to ten years) and the rate of interest could be patterned after the IMF rate, or perhaps made even slightly lower. By being thus cheaper, longer-term and devoid of conditionality, they would be more attractive.

The political advantage for China is clear. The political advantage for poor countries is not to depend on IMF conditionality. And the rate of return on China's loans may not be lower than the risk-adjusted return on its current US holdings. The proposition thus seems to be a triple win.

Of course it would require, from all sides, thinking 'outside the box'. But the unprecedented conditions of war, destruction, rising militarisation and looming hunger require such thinking. If not now, when?

Branko Milanovic

Branko Milanovic is a Serbian-American economist. A development and inequality specialist, he is visiting presidential professor at the Graduate Center of City University of New York and an affiliated senior scholar at the Luxembourg Income Study. He was formerly lead economist in the World Bank's research department.