INSIGHT

Saving face

Jerome A. Cohen says Beijing should look to restart negotiations with the Philippines after the upcoming ruling on the South China Sea dispute, given its impact on regional peace and its own foreign policy

International tensions are rising rapidly as D-Day approaches in the Philippines arbitration case against China. Increasingly anxious, Beijing is resorting to a full-court press in the propaganda realm, seeking to justify its refusal to participate in the proceedings, and it has rejected in advance the forthcoming decision of the distinguished arbitration panel of five independent maritime experts. Both the Chinese Society of International Law and the All China Lawyers Association have just issued dutiful supporting arguments.

Rumour even has it that the People's Republic, by enticing many landlocked autocracies and other smaller states with no apparent interest in the South China Sea to endorse its position, may seek to delegitimise the arbitration decision through a majority vote in the UN General Assembly or some other international forum.

The Philippines, by contrast, has done relatively little to publicly lobby its case with the world community, even while doing an excellent job in presenting its legal claims to the tribunal it convened in accordance with the UN Convention on the Law of the Sea. The controversial election of its new president, Rodrigo Duterte, who will take office on July 1, has created uncertainty about how his government might build upon the platform that the arbitration decision may give him for a better bargaining position in any renewal of previously unsuccessful maritime negotiations with China. There are even recent indications that Duterte might soften his country's maritime position in exchange for massive Chinese economic assistance.

Taiwan finds itself in a third distinctive position. The recently departed administration of president Ma Ying-jeou, himself an international law specialist, went all out to persuade both the world and the tribunal that Taiping Island (Itu Aba), the largest of the disputed Spratly chain and the only one that Taiwan occupies, deserves a 200-nautical-mile "exclusive economic zone". Taipei and Beijing, because they both claim to represent China, take similar positions regarding many of the issues at stake in the arbitration. Yet Taipei, it should be emphasised, unlike Beijing, does not seek to discredit either the tribunal's proceedings or the arbitrators.

Taiwan does not challenge the legitimacy of the tribunal's anticipated application of the Law of the Sea. Quite the contrary, it bemoans the fact that it has been denied the opportunity to take part in the proceedings because of its exclusion from representation in the UN. Nevertheless, it has sought to influence the tribunal's decision about the merits of the issue through submission of an uninvited but skillful "friend of the court" brief prepared by its Chinese (Taiwan) Society of International Law.

To what extent Taiwan's newly elected government, led by the able law scholar Tsai Ing-wen, will alter the legal stands taken by the Ma government concerning the South China Sea remains to be seen. On a related question, apparently in order not to offend Japan, it has made a milder response than Ma to Tokyo's spurious claim that the spit of land it calls Okinotori Island to the east of Taiwan is entitled to an exclusive economic zone.

Moreover, Tsai's defence minister has just announced that their new government would refuse to recognise any "air defence identification zone" that China might declare after the arbitration decision, in complete disregard of the concerns of its neighbours, a line similar to Washington's.

The United States, increasingly aware of the significance of the forthcoming decision, has not been a passive witness to these disturbing developments. The Obama administration has emphatically addressed the issues through both unusually publicised naval manoeuvres and vigorous diplomatic actions. It has mobilised ever greater direct and indirect pressure upon Beijing to reconsider its refusal to honour its obligation, as a member of the UN convention, to obey the arbitration decision.

The G7, for example, under American influence, has twice recently issued strong statements to this effect. President Barack Obama has also belatedly asked the US Senate to again consider granting consent to American ratification of the UN convention, which it has shamefully withheld for over three decades, leaving the US in the embarrassing position of supporting the convention from the sidelines.

Moreover, many American non-governmental experts in international law and politics have emphasised the arbitration's importance for China's foreign policy, peace in

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Southeast Asia and a rules-based world community. The American Society of International Law discussed the issues in April at its annual meeting and included two Chinese experts, who found themselves in rough waters. The Council on Foreign Relations, the Centre for Strategic and International Studies and other prominent think tanks as well as universities have had a number of similar programmes, and quite a few relevant editorials, op-eds and longer articles have been published in major American newspapers and magazines.

China, now evidently worried that it will be condemned by the world community, has been forced to seek support from Mozambique, Slovenia, Burundi and many other weak and distant states. This is ironic, of course, since Beijing has until now argued that powerful states like the US, Japan and India that oppose China on this matter have no right to address it, because they do not border the South China Sea, .

Russia, having recently been diminished by its refusal to accept the jurisdiction of another Law of the Sea arbitration panel, has announced its neutrality on South China Sea questions. After losing its dispute with the Netherlands over seizure of a Dutch-flagged Greenpeace ship and crew, Russia found a face-saving way to comply with most of the tribunal's decision without recognising its jurisdiction. Moscow claimed it released the ship and crew in accordance with its national law!

In losing its Law of the Sea dispute with Bangladesh over the Bay of Bengal in 2014, India showed how great powers should accept the decision of an expert panel of independent arbitrators and renew negotiations on that basis.

China and the Philippines, after the arbitration decision, can renew their negotiations and settle the issues by taking account of the decision without formally mentioning it. "Face" is crucial, of course. But with every Beijing propaganda blast, it will become harder to save.

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Worries about a sharp slide in the yuan are overblown

Joe Zhang says China can effectively raise the value of its currency if it wants to, to calm jitters about the impact of a US interest rate hike. But it has made no such move, because it doesn't need to

Most China watchers have a very firm belief that the renminbi is significantly overvalued and that it is due to depreciate sharply at some stage, probably in the near future.

Their conviction grows as an interest rate hike by the US Federal Reserve becomes increasingly likely. Each release of economic data from China, and Beijing's tightening of capital outflows, become extra reasons for the pessimists to reiterate their forecast.

However, this fervent belief is odd if one considers the glaring absence of a black market for foreign exchange in China. Recall that, in the 1970s through to the late 1990s, an active black market was a prominent phenomenon. The exchange rates often deviated 50 or even 100 per cent from the official rates as a result.

There was so much imbalance between demand for, and supply of, foreign exchange that, in 1980, the People's Bank of China introduced a foreign exchange certificate as a rationing mechanism. Almost immediately, it became a separately traded asset class. Even employees of the central bank (like myself) had to resort to the black market to buy foreign exchange to fund overseas education or purchases of imported goods.

This dual-track currency regime faded away only when the renminbi started to strengthen in the early 2000s.

Today, China still controls the renminbi's exchange rates and capital flows, but each individual Chinese citizen is allowed to buy US$50,000 a year from any bank. Moreover, if you want to buy more foreign currency, you can easily borrow the quota from your neighbours, friends and even total strangers. Indeed, many businesses inflate their import bills and under-invoice their exports in a bid to keep more foreign exchange outside China.

Many also send their money to overseas destinations through the acquisition of foreign businesses. These activities have led to all sorts of abnormalities in China's data on balance of payments. While these factors fuel the pessimists' forecasts, I see them as confirmation that the renminbi is rock solid, precisely because the pressure on it is being released every day.

It is a big mistake to assume that officials at the People's Bank of China are totally unaware of the tricks smart merchants play to send capital overseas. But the fact that the regulators are not enforcing the controls is only because they do not have to, and do not want to.

And their half-hearted enforcement of rules is the only reason why a black market has not re-emerged and why there is only one set (rather than multiple sets) of exchange rates.

My interviews with a large number of businesspeople and consumers suggest that they encounter no real hurdles in accessing and transferring foreign exchange.

Some say they are put off by low returns in foreign countries. Many see merit in having some assets outside China. But, still, it is not a high priority for the vast majority of Chinese. Moreover, I feel that outside observers have grossly overstated Chinese people's anxiety about the country's political future.

The Fed may raise interest rates multiple times in the years ahead. But even if it were to double or triple its rates, it would still be just a small factor in the consideration of asset diversification for Chinese investors.

The same can be said about interest rate changes introduced by the People's Bank of China. In Europe and the US, analysts pay attention to a rate change of 25 basis points, but in China, the central bank must lift or cut rates by

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100 and even 200 basis points if it really expects to make a meaningful impact on the economy.

Why does China need a much bigger dose to jolt the market? Many other factors reinforce or offset the efficacy of central bank policies. For example, making tax collections or red tape slightly easier can benefit businesses much more than tinkering with the currency or the interest rates.

The renminbi may be overvalued. But it is easy to overstate the case. China may have lost some competitiveness to other developing countries, but to the envy of many of its trading partners, it still reports a trade surplus of between US$50 billion and US$60 billion each month, and that's the surest proof of competitiveness in external trade. Controls or not, the renminbi has been the strongest major currency (even beating the US dollar) in the past 15 years.

Beijing can, if it wants to, tough it out on the currency front. For example, if it is willing to allow its foreign reserves to halve from the current level of US$3.5 trillion, it can send the renminbi significantly higher, thereby reversing all those gloomy forecasts. As the renminbi is increasingly adopted as a medium of exchange in China's external trade, the foreign reserves are falling in relevance.

Short-sellers know this all too well: just because a stock is overvalued does not mean it will weaken next month or even next year. Similar to the fair valuation for a stock, a currency's fair value is a very wide range, instead of a precise magic number.

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Tax hike delay a sign of Japan's deep malaise

Kevin Rafferty says Shinzo Abe's postponement of a long-planned increase in consumption tax will only entrench the country's indebtedness, and Abe's mishandling is to blame

After dithering for months, Japan's Prime Minister Shinzo Abe decided to dance with the devil and postpone the rise in the consumption tax rate until after he is supposed to leave office.

At one level, we can all sympathise; it is not easy being caught between the devil and the deep blue sea. But Abe's indecision tells a tale of poor leadership and wretched economic and political prospects for Japan. Abe's dilemma was: if he increased the tax, as promised under law, he would risk tipping the already fragile economy into recession; but if he postponed, he would entrench Japan's already heavy indebtedness, with government spending far outrunning its income.

The long-planned rise in the tax rate, from a modest 8 per cent to 10 per cent, is small. But there is an important issue of principle involved, as well as practical economics and politics that will prove a continuing headache for Abe and his successors. Abe is supposed to step down in 2018; he put off the increase until October 2019. Abe had already postponed the tax rise once and promised there would not be further backsliding. So much for political promises.

Japan's consumption tax is low by global standards. People in other rich countries commonly pay 15 to 25 per cent in consumption taxes or value-added taxes. Respected economists calculated that the tax should go to 22-25 per cent if Japan is to keep up with the increasing demands for health, welfare and pension payments of its rapidly ageing society.

In April, Angel Gurria, head of the Organisation for Economic Cooperation and Development, called for the tax hike to go ahead, and said Japan should raise it by 1 percentage point each year until it reaches 15 per cent.

Nobel laureates, including Joseph Stiglitz and Paul Krugman, visited Abe in March, and separately urged that he delay the rise, giving Abe intellectual cover. Koichi Hamada, emeritus professor at Yale, often known as "the godfather of Abenomics", also supported postponement.

Abe, however, insisted the tax hike would go ahead unless there was a major disaster. Last month, he tried

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– unsuccessfully – to persuade other leaders of the G7 that the world was facing economic disaster. Finally, he decided to postpone the tax hike anyway, just before announcing the date of upper house elections in July. This was surely grubby domestic politics.

It can only get worse. Abe said he would wave his magic wand of Abenomics again, and all would be well. He claimed Japan's primary budget, meaning without the heavy interest payments on debt, would be in balance by 2020, surely an exercise in wishful thinking or inventive arithmetic.

Japan's budget deficit has been slightly reduced, but is still running at 6 per cent of gross domestic product as the country's total debts balloon to 250 per cent of GDP. After the election, Abe is expected to propose a 10 trillion yen (HK$700 billion) stimulus package to boost the economy – and increase Japan's indebtedness.

To be fair to Abe, he has made the right noises about restructuring the economy, bringing more women in and raising pay, but they have proved just noises. One hard truth is that Abe has had years to build a better economic road, but he put his energies into the chimera of making Japan a "normal nation" by throwing off the post-war constitution. Another hard truth is that Japan's deep societal problems cannot be solved by slogans or ministerial fiat. With the additional burden of a declining population, Japan needs some special magic if it is to stave off insolvency – including, at least, raising the animal spirits of the population; encouraging a new hi-tech revolution; and an injection of the energy of substantial numbers of immigrants.

None of these items is on Japan's political agenda. That's the other hard truth – that there is too little critical discussion of the real issues and the difficult solutions. Like a frog luxuriating in warm water coming to the boil, Abe, Japan's politicians, bureaucrats, academics, media and the general population are enjoying relatively pleasant economic times, not having the courage to face a grim future.

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Japan's Shinzo Abe at the House of Representatives on the day he announced the tax rise delay. Photo: AFP