The Trade-Finance Disconnect: Geopolitical Repricing and its Consequences

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The trade-finance disconnect

- Are we moving into a bi-polar world?
  - Examine (excess) bilateral trade/financial flows to China and US
  - Utilize workhorse gravity model in international trade and finance literature
    - ✓ Bergstrand (1985), Anderson and Wincoop (2004), Portes and Rey (2005)

- Resilient trade flows but geopolitical repricing for financial flows
  - Trade flows from advanced economies → China resilient
  - Financial flows (particularly equity flows) decreased from advanced economies to China, sharply increased to the US

- How will this trade-finance disconnect play out?
  - Outcome 1: Financial flows overreacted, reconnect
  - Outcome 2: Trade connection to deteriorate, leading to a fractured bipolar world
    - ✓ Bad for efficiency/risk sharing
    - ✓ Unexpected gain of diversification though

Trade flows have remained resilient

- Advanced economies trade with China resilient even after 2018
  - Most have increased trade intensity (% of GDP)
  - Sino-US intensity sharply dropped in 2018, but rebounded from 2019 to 2021
  - Reflects China’s comprehensive manufacturing capacities and pragmatism of businesses
- Trade between these countries and US also fairly strong
- Emerging economies trade increasingly more with China

Figure 2: Advanced Economies Trade Intensities

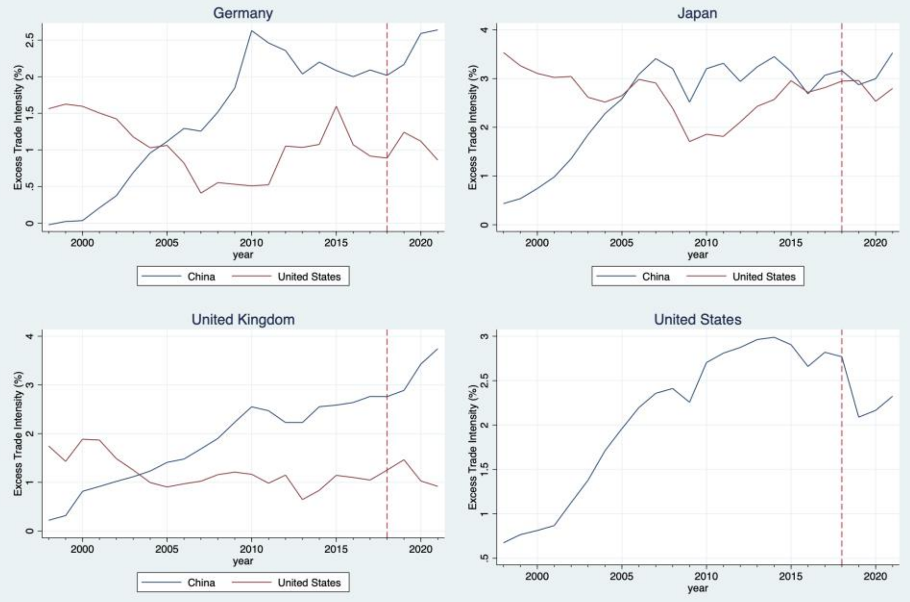
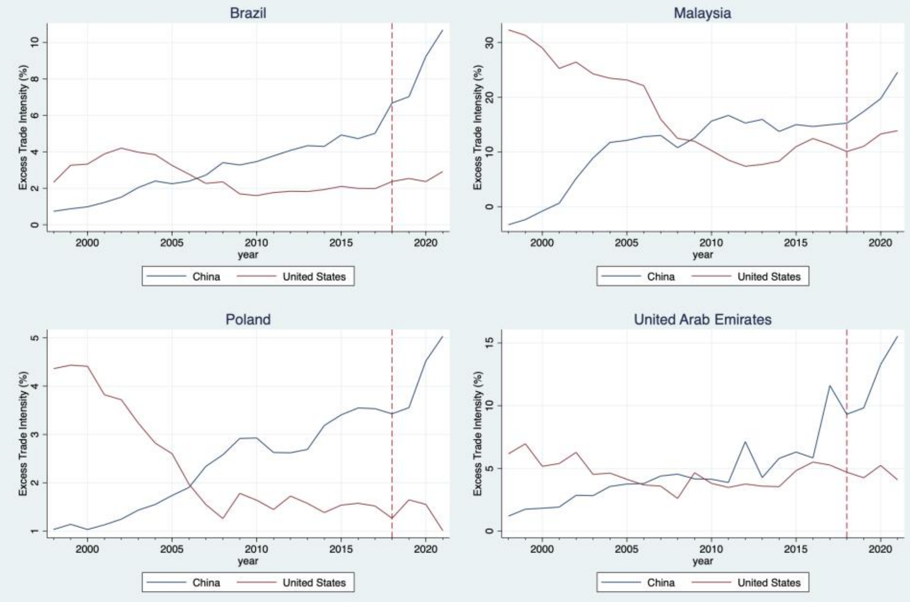


Figure 3: Emerging Economies Trade Intensities



Geopolitical repricing for financial flows

- After Sino-US trade friction, equity flows strongest signs of geopolitical repricing
  - Advanced economy flows to China ↓, to US ↑↑
  - India and South Korea flows to China ↓, to US ↑↑
  - Other emerging markets increased flows to US, but not at expense of flows to China
- Limited evidence of geopolitical repricing for bond flows
  - "Insurance" through US became expensive (Gourinchas, Rey, and Truempler, 2012; Gourinchas, Rey, and Govillot, 2022)
  - Floating exchange rates reduced the need for holding US treasuries (Miao, 2019; Miao, Fei, and Li, 2022)
- Some evidence of fracturing of FDI flows
  - Traditional US allies have increased excess FDI flows into the US, though much more muted compared to equity
  - No evidence of fracturing for rest of the world

Figure 4: Advanced Economies Equity Intensities

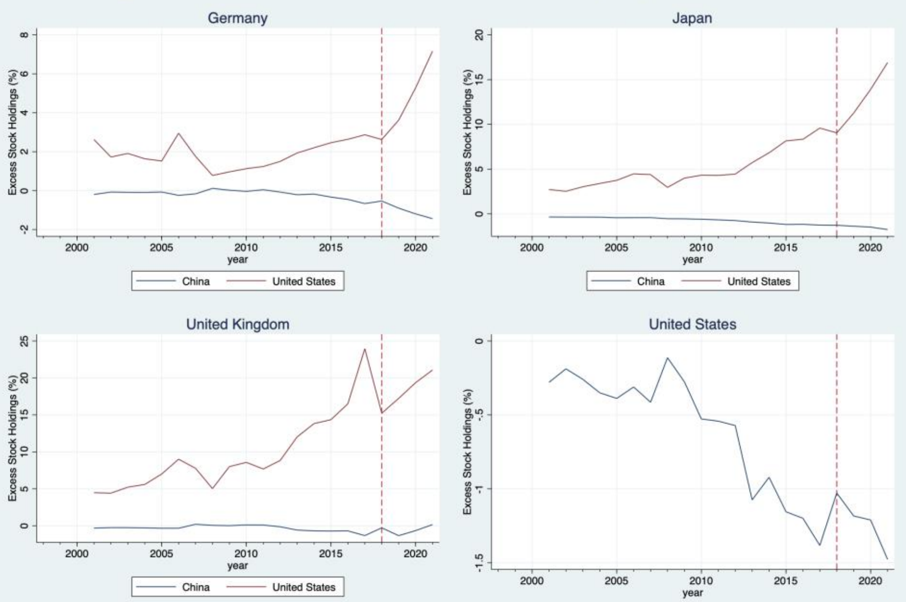
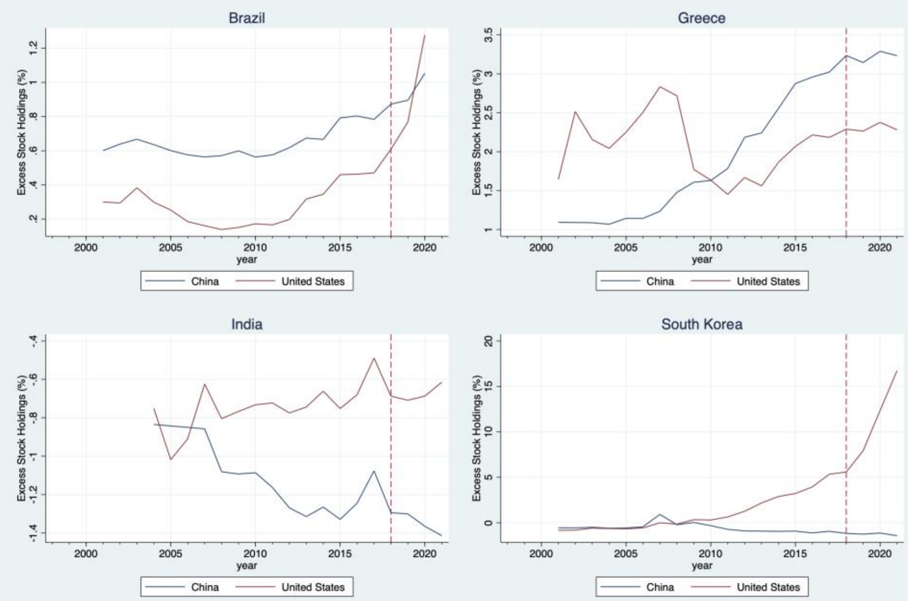


Figure 6: Emerging Economies Equity Intensities



Why geopolitical repricing in equity flows?

- Our hypothesis: Equity flows more sensitive to geopolitical tensions
  - Alternative hypothesis: Advanced economies shifting of investments purely economic
- Decompose/quantify three drivers of Chinese and US equity returns
  - risk-free rate, equity risk premium, and earnings growth
- Equity risk premium dominant for China, earnings growth dominant for US
  - China ERP highly sensitive to geopolitical shocks, US ERP very small reaction
  - ERP rise disproportionately in China but not US, driving equity flows out of China
- Changes in excess trade/finance intensities positively correlated with public opinion for China, but not for US

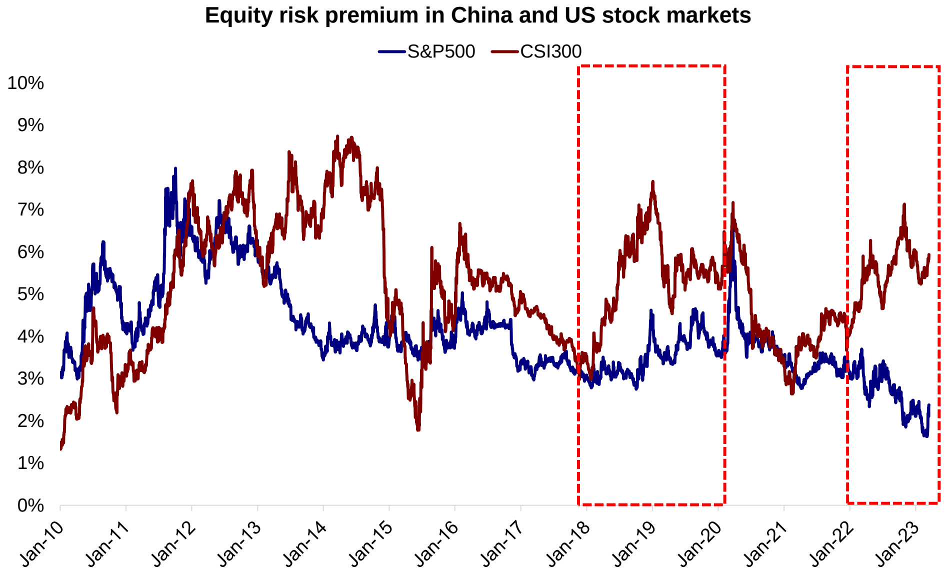


Table 1: Regressing Flows on Public Opinion

	China	US
Excess Trade *b*	0.04***	-0.01
t	(4.09)	(-0.89)
R^2(%)	8.01	0.42
Excess Stock *b*	0.01***	-0.06**
t	(2.92)	(-2.07)
R^2(%)	4.59	2.35
Excess Bond *b*	0.01***	0.001
t	(2.71)	(0.11)
R^2(%)	4.56	0.01
Excess FDI *b*	0.02	-0.05*
t	(0.86)	(-1.74)
R^2(%)	0.40	1.64

Actions today determine future

- Provide stability and improve the international monetary system
- Should enhance the global safety net
  - Most efficient but politically difficult: global currency swap line network
- Encourage financial flows between advanced economies and China
  - Reconnect trade-finance disconnect
  - Advanced economies rising weight of US equity → eggs in one basket
  - China's asset comovement with US low (Miao, 2019b), source of diversification for foreigners
  - China should continue to introduce policies in support of financial reconnect

Figure 12(A): Correlation between US and China's bond yields have fallen over recent years

Source: Bloomberg, Wind, CICC

Figure 12(B): Correlation between US and China's equities have fallen over recent years

Source: Bloomberg, Wind, CICC