CROSS-BORDER INVESTMENT

THE STORY SO FAR

China is deeply engaged with the global economy through trade links, but far less integrated into cross-border capital flows. The country has now reached a development stage where financial account opening is critical for sustaining growth by increasing market discipline and efficiency in financial services, easing the transition to a new economic model, and supporting the competitiveness of Chinese companies. At the same time, policymakers are concerned that, if mismanaged, financial account opening could cause instability and compromise monetary policy independence. In its 2013 Third Plenum Decisions, China pledged to manage the challenges and move ahead with two-way financial market opening and capital account convertibility.

- Beijing has made some progress in inbound foreign direct investment (FDI) reform since 2013. China is moving from an approval-based system to a negative list-based system whereby most foreign investments can proceed without government review except in restricted sectors. Beijing has reduced the scope of this negative list and partially lifted equity share restrictions (joint venture requirements) in financial services and automotive manufacturing.

- China has also broadened the channels for portfolio investment inflows. In addition to special programs (Qualified Foreign Institutional Investor, QFII, and RQFII, the same program denominated in RMB) investors are now able to utilize the Shanghai and Shenzhen to Hong Kong Stock Connect programs for equity investments, and the Bond Connect program to access China's domestic government bond market.

- In April 2019, several Chinese securities were included in the Bloomberg Barclays Global Aggregate Index, the first major global bond index to add Chinese government and policy bank debt. This follows the inclusion of several Chinese large-cap stocks in the MSCI Emerging Markets Index in June 2018, and more major equity and bond indices are likely to follow by adding Chinese debt and equities in the coming years.

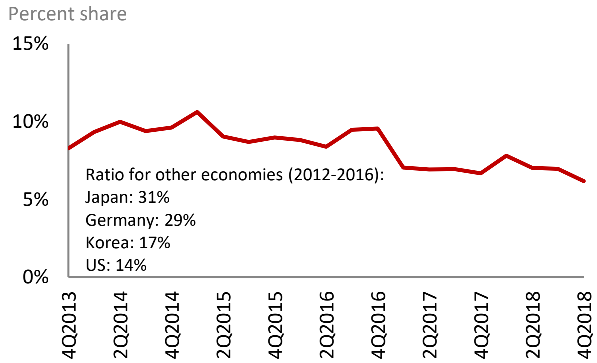
- Meanwhile, China has backpedaled on capital account reforms. In 2014 and 2015, Beijing relaxed rules for outbound FDI, but regulators reversed course after outflows soared, pressuring the balance of payments and the exchange rate. Controls on other capital outflows were also tightened, including outbound portfolio investment and currency conversion by households.

METHODOLOGY

To gauge cross-border investment progress, we sum the volume of capital flows into and out of China on a quarterly basis and divide by gross domestic product (GDP) in the same quarter. This primary indicator of China's degree of financial integration tells us how China's opening to external capital flows is progressing compared to overall economic growth. We supplement this assessment with other indicators of China's integration into global financial markets: the balance of cross-border capital flows by category plus net errors and omissions, the breakdown of inflows and outflows by type, the buying and selling of foreign exchange reserves by China's central bank, the role of foreign buyers in total Chinese mergers and acquisitions, and the share of the Chinese currency in global payments.

QUARTERLY ASSESSMENT AND OUTLOOK

Primary Indicator: External Financial Liberalization



Source: State Administration of Foreign Exchange. National Bureau of Statistics.

- Our assessment moves slightly negative this quarter, from neutral last time. Gross cross-border capital flows as a percentage of GDP declined to the lowest level in six years, at 6.2%, compared to 6.9% in the previous quarter. Despite talk of reform, capital inflows and outflows shrank in late 2018—reflecting a generally sour economic mood.

- Data indicate that capital controls continue to restrict outflows, foreign investor readiness to acquire Chinese securities remains limited, and the central bank continues to intervene actively in foreign exchange markets.

- Beijing is actively courting greater foreign participation in China's financial sector—in securities brokerages, insurance, and banking—out of necessity, and continued movement toward market openness is expected in 2019.

THIS QUARTER'S NUMBERS

To measure Beijing's progress toward its 2013 Third Plenum reform commitments, we track gross **cross-border capital**

flows as a ratio of GDP. By that measure, investment engagement declined late in 2018, with our ratio dropping to the lowest level of the Xi Jinping years. In value terms, 4Q2018 capital flows were the lowest in more than five years, at only $143 billion, and the second-lowest quarterly level since the end of 2010. Full-year 2018 gross flows, including FDI, portfolio investment, and other investment flows from banks, totaled $840 billion, up slightly from $816 billion in 2017 but down from $1.06 trillion in 2016.

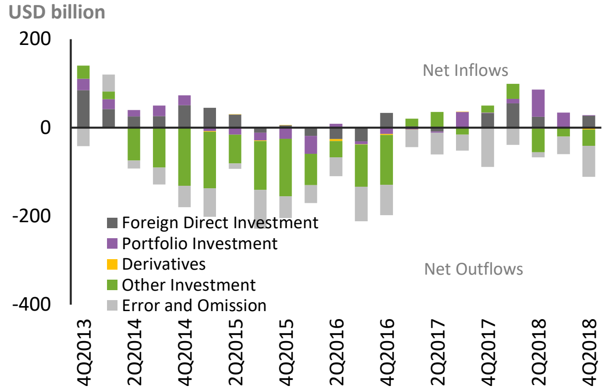
It is difficult to argue that China has become more open to cross-border investment flows in either direction since the Third Plenum reform commitments in 2013. In fact, our primary indicator has not risen much in nominal terms since 2011, and capital flows continue to shrink as a proportion of GDP. China's 6.2% ratio compares to 14% in the United States, and 31% and 29% in Japan and Germany, respectively.

Foreign appetite for China's financial market remains volatile and is driven by short-term changes in interest and exchange rates, not long-term confidence in the regulatory and investment environment. The potential for a game-changing inflow of foreign capital is there, but it has not yet shown up in the evidence. Foreign portfolio inflows, money from global investors into domestic equity and bond markets, declined to only $8.1 billion in 4Q2018 (see **Breakdown of Cross-Border Financial Flows**), after a quarterly average of $50.7 billion in the previous three quarters. While 2019 data will show some recovery, short-term concerns about currency valuations remain a dominant factor in the low inflows.

Overall foreign direct investment inflows—driven largely by corporations less sensitive to financial market conditions—rebounded in 4Q2018 to $52.7 billion from $25.2 billion in 3Q2018, but some year-end improvement is typical. Relatedly, the share of foreign buyers in Chinese mergers and acquisitions (M&A) activity did improve marginally in 4Q2018 back to levels seen earlier in the year, but the overall trend line is still lower since 2013.

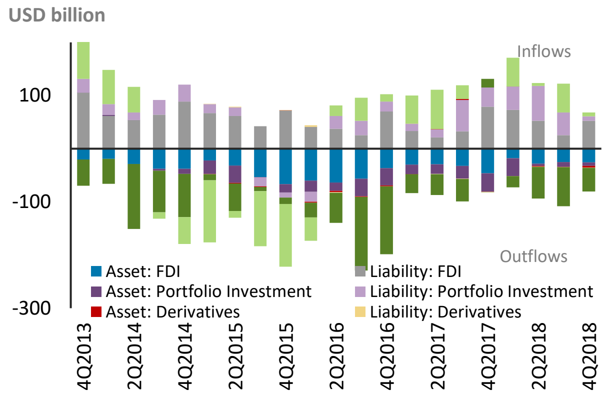
Finally, the data make it clear that currency intervention persists as a feature of macroeconomic management and that the RMB is far more controlled than other major currencies traded in global financial markets, despite government assurances that the exchange rate will be liberalized (see **Currency Intervention**). China posted a foreign exchange reserves decline in 4Q2018 of $28.2 billion, following a $3.1 billion drop in the third quarter. Reserves and inflows have rebounded in early 2019 as global central banks have become more dovish and inflows into emerging markets, including China, have consequently improved. The central bank has continued intervening in a one-sided manner, allowing some appreciation early in 2019 while resisting depreciation pressure, though the RMB slid against the dollar in mid-May as bilateral trade tensions escalated. Depreciation is an irritant with Washington, even when merited and necessary for China to fulfill long-term commitments to exchange rate flexibility.

Supplemental 1: Net Capital Flows



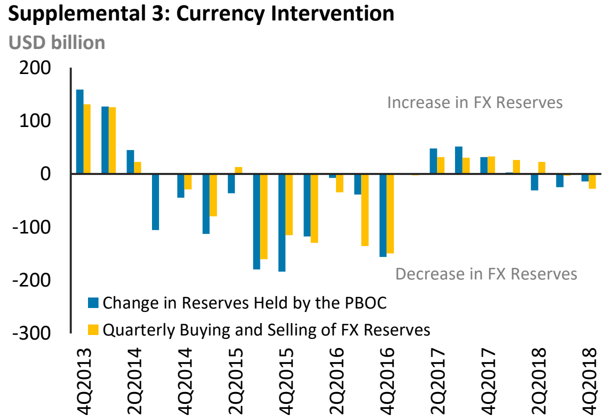
Source: State Administration of Foreign Exchange.

Supplemental 2: Breakdown of Cross-Border Financial Flows



Source: State Administration of Foreign Exchange.

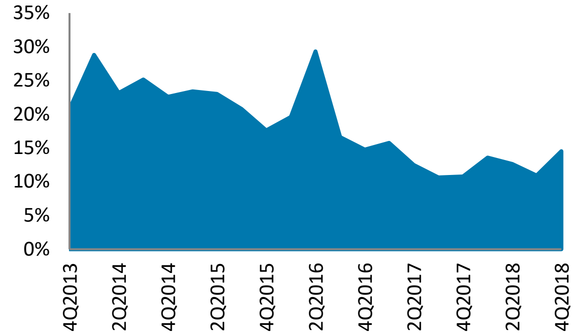
Supplemental 3: Currency Intervention



Source: State Administration for Industry & Commerce, Rhodium Group.

Supplemental 4: Foreign Appetite and Market Access

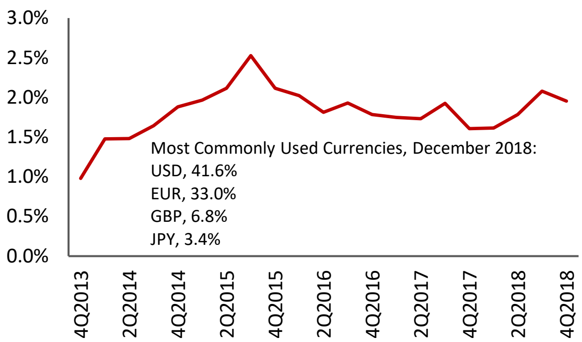
Percentage



Source: Bloomberg. Announced deals tabulated by date of announcement and include all completed, proposed, and withdrawn deals

Supplemental 5: Globalization of China's Currency

Percent of Chinese Yuan (RMB) Usage in Global Transactions



Source: SWIFT.

POLICY ANALYSIS

The need to promote cross-border capital flows is at the heart of today's reform debate in China. With a huge appetite for foreign capital to balance the natural desire of Chinese firms and savers to diversify some of their wealth abroad, the question is whether Beijing will turn to liberalization to attract foreign investment or, rather, use administrative controls to force capital already inside China to stay there. Since late 2017, leading voices in financial policy have intimated that reforms are imminent, including relaxation of restrictions on foreign equity in brokerages and insurance firms. In the most recent quarters, this has gone into higher gear, with technocrats making adjustments to facilitate Chinese inclusion in global bond and equity indices. Investment flows are an independent indicator of confidence — or hesitation — in China's future and officials are eager for optimistic signals.

Significantly, Beijing approved a new Foreign Investment Law at the annual National People's Congress early in 2019. The law pledges to protect intellectual property rights and prohibit forced technology transfers in the context of inbound investment. It also guarantees "pre-establishment national treatment" for foreign investors and prohibits local governments from circumventing national policies. These are improvements on paper, but most foreign firms and governments remain uncertain whether this will deliver the symmetric investment conditions they require. Implementing regulations from relevant line ministries, including the Ministry of Commerce, National Development and Reform Commission, and the China Banking and Insurance Regulatory Commission, in the months ahead will be key.

Financial sector liberalization to attract foreign investment has been promising over the past six months. Given rising pressure for liberalization from abroad, opening China's financial sector to majority stakes by foreign investors is one of the easier commitments for Beijing to make: China needs to attract foreign inflows anyway. In 4Q2018, the China Securities Regulatory Commission (CSRC) approved UBS's application to hold a majority stake in its China securities joint venture, making it the first *foreign-controlled* brokerage in China. This may pave the way for a more comprehensive relaxation of foreign ownership restrictions in securities brokerages.

Other steps to increase portfolio inflows are afoot. Chinese government and policy bank bonds were added to the Bloomberg Barclays Global Aggregate Index on April 1 as part of a 20-month process that will eventually bring Chinese assets to around 6% of the global index. This follows the introduction of Chinese equities into the MSCI Emerging Markets Index in June 2018, and into the FTSE Russell Emerging Markets index effective in June 2019. These passive bond and equity indices *should* encourage foreign inflows into China's financial markets, but ultimately this depends on whether individual investors want this exposure. In addition, draft rules circulated by the CSRC in early February have proposed unifying the QFII and RQFII programs to simplify regulations and improve investor access, while allowing foreign investors to access financing for investment onshore, rather than bear exchange risk from bringing in assets from abroad as well.

In the insurance sector, reports indicate preparations to allow foreign firms to control their onshore joint ventures, and eventually own them outright. In November 2017, Beijing pledged to increase foreign ownership limits to 51% and abolish those limits within three years. In November 2018, the French insurer AXA bought out its domestic joint venture partner to take complete control, and Allianz was approved to set up a wholly owned insurance holding company in 2019. But promised details scheduled for early 2019 have not yet materialized, and formal and informal barriers beyond equity cap limits remain that are not directly addressed in new guidelines.