

Cross-border Investment

The Story So Far

China is deeply engaged with the global economy through trade links, but it is 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 these 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 in which 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 Investment, QFII, and RQFII, the same program denominated in RMB), investors are now able to use 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 Bond Index, the first major global bond index to add Chinese government and policy bank debt. This followed the inclusion of several Chinese large-cap stocks in the MSCI Emerging Markets Index in June 2018. 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.

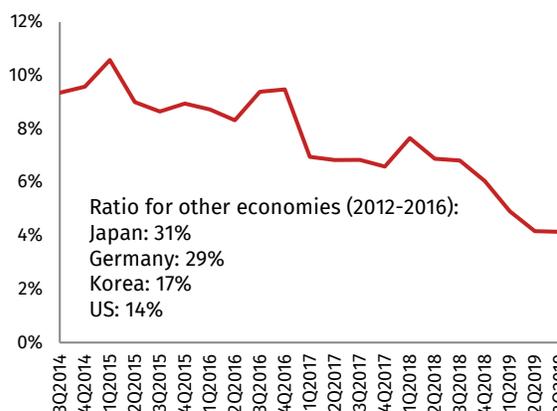
Methodology

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 with 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

Gross sum of cross-border investment flows under China’s financial account (excluding reserves) as a share of GDP, year to date, percent



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

- We slightly upgrade our assessment due to stronger portfolio inflows over the past two quarters, but overall capital flows remain far too small for an economy of China’s size.
- Capital outflows remain persistent. Foreign direct investment (FDI) inflows were seasonally low, causing the FDI balance to return to a deficit after more than two years. Foreign investors accounted for a bigger share of domestic mergers and acquisitions as overall deal flow cooled.

- Policy measures continue to facilitate inflows into China’s equity and bond markets. FDI inflows should pick up following the planned 2020 elimination of foreign equity caps for the insurance, brokerage, and asset management sectors.

This Quarter’s Numbers

Overall, China remains generally closed to capital inflows and outflows relative to more developed economies and has become relatively less open since the 2013 Third Plenum. Compared to the United States, with gross cross-border capital flows equal to 14% of GDP – or Germany (29%) and Japan (31%) – China only sees flows representing 4.15% of GDP (see **External Financial Liberalization**). Both inflows and outflows declined in 3Q2019 relative to 2Q2019 and in year-on-year terms, reflecting some seasonality, as FDI flows are usually weaker in the third quarter of the year.

However, the decline in China’s proportion of flows slowed for the first time in a year. Capital outflows are still sizeable and indicate persistent diversification from China’s large pools of household and corporate savings into foreign assets. This trend explains the large volume of outflows categorized as “errors and omissions” over the past three years and will continue despite capital controls. Outflows under the more market-sensitive “other investment” account also increased in 3Q2019, producing a deficit of \$38.9 billion during the quarter, adding on to \$39.4 billion in errors and omissions-related outflows (see **Net Capital Flows**).

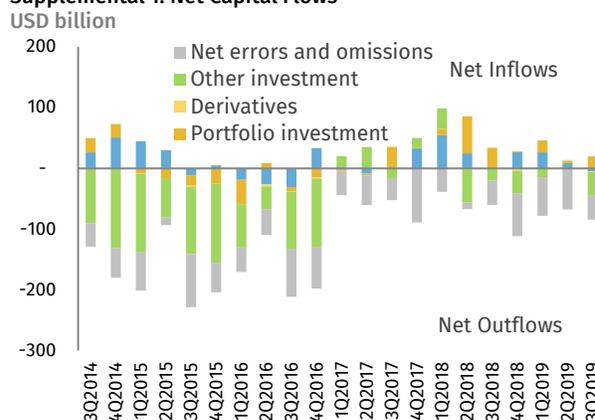
It is less certain whether potential sources of inflows *can* offset these persistent outflows. Foreign portfolio inflows offered a positive sign with a net surplus of \$20.0 billion in 3Q2019 as foreign investors followed major bond and equity indices and increased investments in China’s onshore financial markets, usually through the Hong Kong-based Bond Connect and Stock Connect programs.

FDI flows returned to deficit for the first time since 2Q2017, falling to \$5.1 billion in 3Q2019 (see **Breakdown of Cross-Border Financial Flows**). Third-quarter FDI inflows are typically seasonally low, but it is also possible that uncertainty related to the U.S.-China trade conflict depressed inbound transactions. Despite weaker FDI inflows, foreign buyers accounted for a larger proportion of acquisitions of Chinese companies in 3Q2019 (16%) than in 2Q2019 (13%) (see **Foreign Appetite and Market Access**). This increase, however, was not attributable to a rise in actual foreign mergers and acquisitions (M&As), but a cooldown in overall deal flow in 2019 amid policy uncertainty and the growing perception that China’s tech sector is overheated. M&As in China have fallen by 23%

year-on-year (yoy) through the first nine months of 2019, and deals with all Chinese buyers have fallen 26% yoy, while foreign deals are relatively stable.

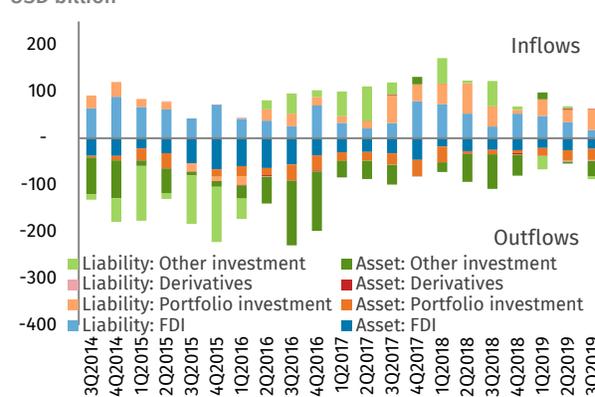
The central bank continued to intervene to sell foreign exchange reserves and defend the currency in 3Q2019 to the tune of \$16 billion, according to balance of payments data (see **FX Reserves**). Nonetheless, intervention has slowed over time, particularly since the heavier capital outflows seen in 2015 and 2016. International use of the currency remains limited, with our indicator of **Currency Internationalization** barely ticking up to 1.99% of global transactions, showing no significant movement over the past three years.

Supplemental 1: Net Capital Flows



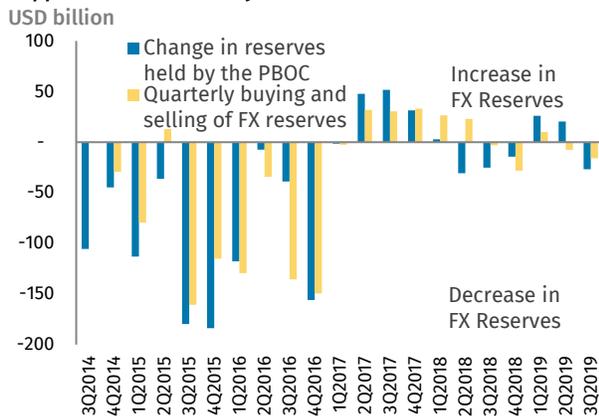
Source: State Administration of Foreign Exchange.

Supplemental 2: Breakdown of Cross-Border Financial Flows



Source: State Administration of Foreign Exchange.

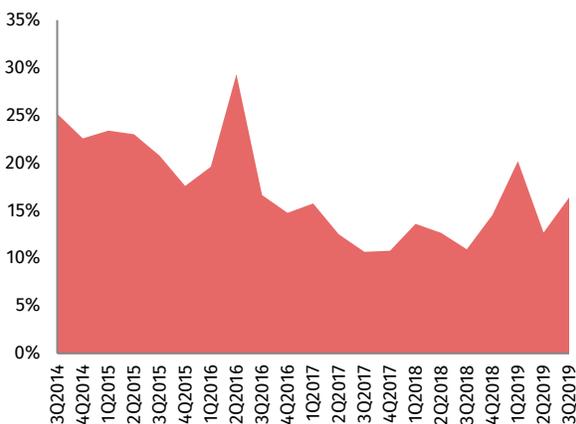
Supplemental 3: Currency Intervention



Source: State Administration of Foreign Exchange, Rhodium Group.

Supplemental 4: Foreign Appetite and Market Access

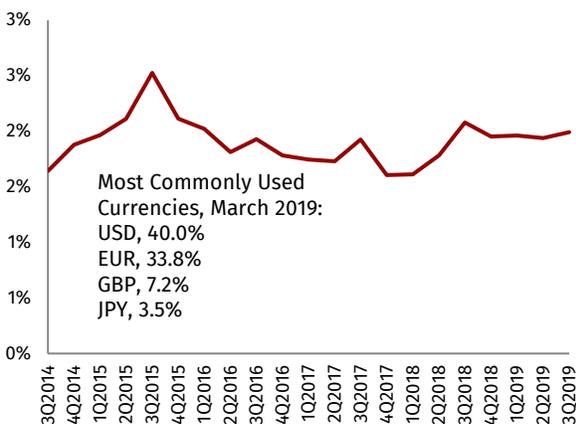
Share of deals with foreign buyers in total number of acquisitions with Chinese target, percentage



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

Supplemental 5: Globalization of China's Currency

Chinese yuan (RMB) usage in global transactions, percent



Source: SWIFT.

Policy Analysis

The key question in assessing cross-border investment reform is how rapidly and credibly Chinese authorities can commit to greater openness to capital flows in both directions. So far, reforms have advanced in the direction of permitting more inflows gradually, particularly in new areas of China's financial system, but progress toward liberalization of outbound flows remains limited.

Over the past six months, Beijing continued to implement previous promises aimed at improving market access for foreign investment into China. The State Council released "Amendments to Regulations in the Finance Sector" on October 15, paving the way for implementing announced liberalization in the banking and insurance sectors. One week later, the State Administration of Foreign Exchange issued a circular to further promote and facilitate cross-border trade and investment, including measures to relax some restrictions on additional equity investment by foreign-invested enterprises (FIEs) within China. Finally, on January 1, 2020, China's new FDI law officially went into effect. A new implementation document was released, which provides more detail but does not spell out how key provisions, such as improved intellectual property rights (IPR) protection, are going to be enforced.

Some progress has been made in opening the automotive industry. An October State Council Regular Meeting confirmed that a new regulatory point system for electric vehicle (EV) manufacturing applies equally to domestic and foreign players. The lifting of equity cap restrictions in EV manufacturing in 2018 has already led to several new investments, including by Tesla). Looking forward, restrictions for commercial vehicles and passenger cars are to be removed in 2020 and 2022, respectively, potentially setting up the industry to receive a wave of FDI in the next few years, even though the automotive market is shrinking and the short-term outlook for China's auto industry is fraught due to messy implementation of emissions standards.

The Phase 1 trade deal between the United States and China is expected to promote inbound direct investment into China's financial sector, provided it succeeds in reducing political uncertainty in the bilateral relationship. China had already pledged to eliminate equity caps on foreign investment in several sectors, including insurance, fund management, and securities. The Phase 1 deal accelerated that opening for securities firms to April 1, 2020, while foreign equity ownership limitations on futures companies were already eliminated as of January 1, 2020. The test of these opening measures is really the size of the flows that ensue; in the past, Beijing has often used licensing requirements and application delays to limit

foreign competition even in nominally open sectors. But with this opening captured in the Phase 1 deal, the incentive to encourage additional foreign inbound investment to balance persistent outflows is now stronger.

One surprising aspect of the deal was a pledge to allow foreign firms to acquire asset management company licenses in the distressed debt industry, enabling them to buy nonperforming assets directly from banks at the provincial level. While no national licenses were granted, limiting the potential opportunity, it is likely that foreign investment in China's distressed debt market will expand given China's eagerness to find alternative buyers for bad debt and foreign investors' interest in a rapidly growing segment of China's financial system.

Another positive sign for reform is China's encouragement of portfolio inflows, particularly to the government and policy bank bond markets. Gross portfolio inflows averaged only \$50 billion per year from 2014 to 2016 and since then have increased to an annualized pace of \$142 billion per year. Chinese securities are expected to be weighted more heavily in global bond and equity indices in the coming years. However, the volume of portfolio inflows is not yet game changing for the stability of China's balance of payments position or for cross-border investment reform. Foreign investors may acquire greater proportions of bonds in China's government bond market, but overall investments will be limited as long as concerns about capital controls and currency risks (without appropriate hedging instruments) remain. China's capital markets are still opening far too slowly, at a time when the window for more aggressive foreign investment in the Chinese economy overall may also be closing, given uncertainties about future potential growth arising from delays in basic reforms.