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

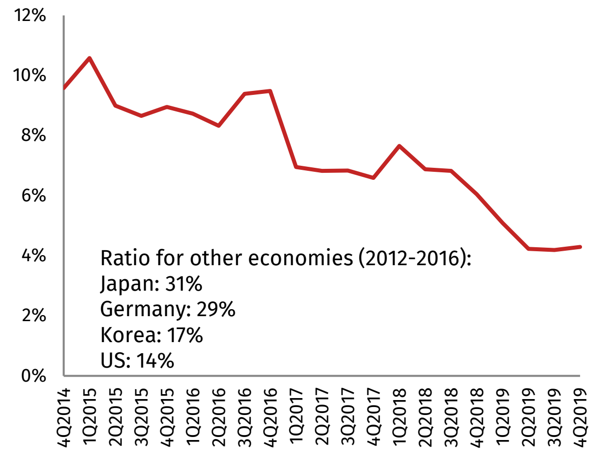
- Our assessment of cross-border investment liberalization remains negative for 4Q2019. Most indicators of China's openness to capital flows showed no improvement.
- Overall capital flows picked up in 4Q2019, but portfolio inflows moderated despite efforts to promote them. Relative to the size of China's economy, cross-border finance remains diminished compared to the beginning of the Xi Jinping era.
- Beijing encouraged foreign inflows but continued to limit outbound investment, and domestic economic concerns make that unlikely to change. In spring 2020, concerned about the impact of COVID-19 on investor expectations, Beijing lifted quotas on some portfolio inflows.

This Quarter's Numbers

China's openness to cross-border capital flows has not improved meaningfully. We saw the first uptick in **External Financial Liberalization** since 1Q2018, but mostly from typical year-end effects when foreign direct investment (FDI) transactions are recognized. Compared to the United States, with gross cross-border capital flows equal to 14% of GDP—or Germany (29%) and Japan (31%)—China has two-way flows amounting to little more than 4% of GDP, down from 9% in 2014.

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.

Households and corporates continue to move savings outside China, where returns are higher. Capital outflows are revealed in the "other investment" balance, which showed net outflows of $37.4 billion in 4Q2019, and through "errors and omissions," which rose to $63.6 billion (see **Net Capital Flows**). Total errors and omissions outflows were $198 billion in 2019, larger than the whole current account surplus, totaling $141 billion. Capital controls reduced FDI outflows to around $24 billion per quarter in 2019, down considerably from 2018.

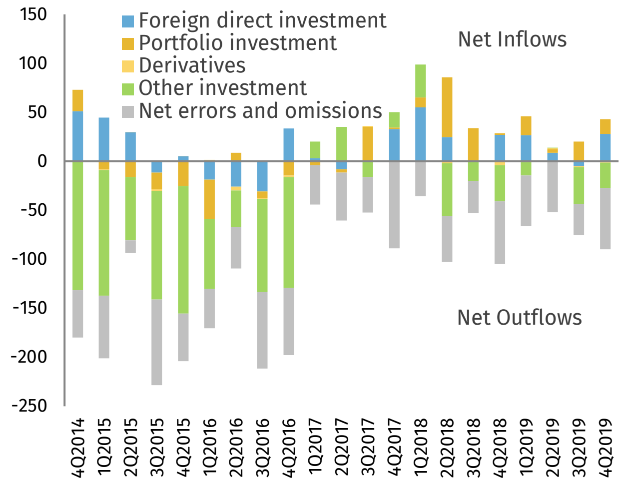
Portfolio inflows into equity and bond markets are still slow in materializing. Both inflows and outflows remained unchanged in 4Q2019 from the previous quarter. Inflows reached $41 billion in the fourth quarter, bringing full-year portfolio inflows to $147 billion—a decline from $160 billion in portfolio inflows in 2018 (see **Breakdown of Cross-Border Financial Flows**).

Foreign exchange reserves declined modestly in 2019, with Beijing intervening to avert trade war-related currency weakness (see **FX Reserves**). The central bank did not appear to change currency (RMB) management policy; instead, it sought to remain as neutral as possible amid sensitive bilateral trade negotiations with the United States. RMB internationalization remained a distant goal, with the currency used in just 1.84% of global transactions in 4Q2019, down from more than 2% (see **Currency Internationalization**). That is trivial compared to other currencies, including several issued by countries with much smaller economies than China's.

There was no growth in foreign participation in mergers and acquisitions of Chinese firms. The proportion of deals involving foreign buyers fell to 12% in 4Q2019 from 16% in 3Q2019, in line with the 2017–2019 average of 14% (see **Foreign Appetite and Market Access**).

Supplemental 1: Net Capital Flows

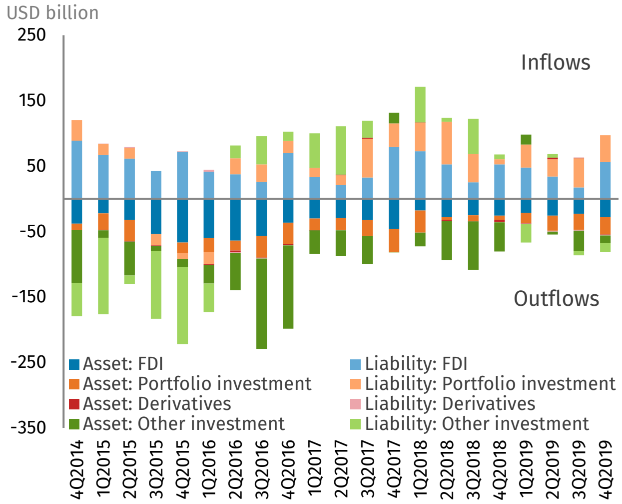
USD billion



Source: State Administration of Foreign Exchange.

Supplemental 2: Breakdown of Cross-Border Financial Flows

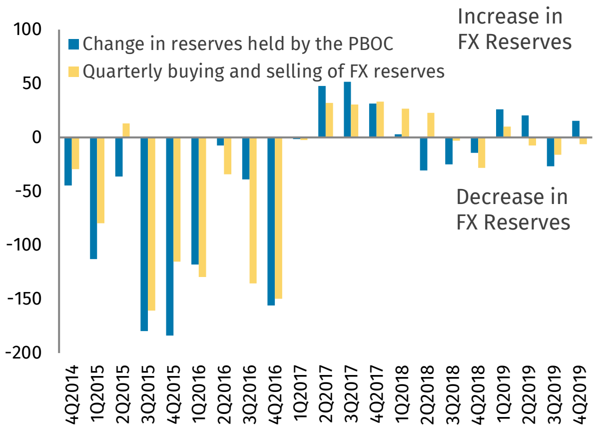
USD billion



Source: State Administration of Foreign Exchange.

Supplemental 3: Currency Intervention

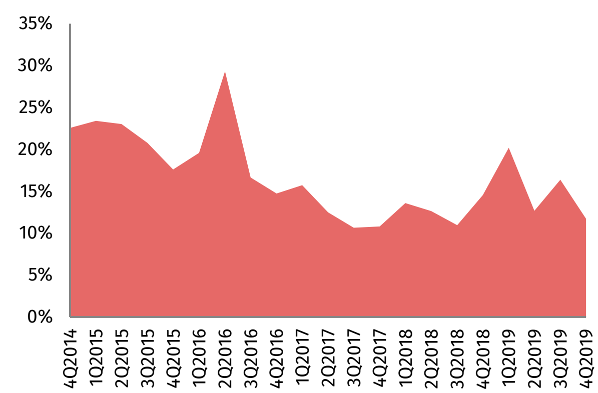
USD billion



Source: State Administration of Foreign Exchange, Rhodium Group.

Supplemental 4: Foreign Appetite and Market Access

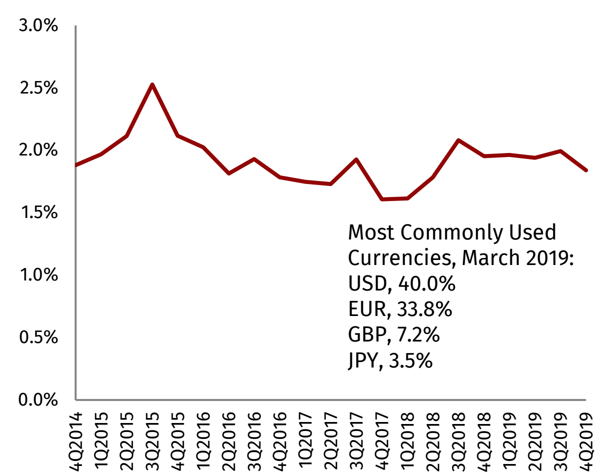
Share of deals with foreign buyers in total number of acquisitions with Chinese target, percentage



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

External forces shaped reform dynamics this quarter. The Phase One trade agreement with the United States promised equity market opening, but the COVID-19 outbreak has obscured the picture. The agreement also announced dates for previous liberalization commitments, such as removal of restrictions on foreign insurance companies by April 1, 2020, and promised faster approvals for long-standing financial services license requests (some of which have now been granted).

The COVID-19 outbreak creates new urgency to promote foreign investment, but concerns about outflows remain. In March, the Ministry of Commerce (MOFCOM) sought public comment on revisions to the Catalog on Encouraged Foreign Investment Industries, a document that guides inbound FDI. Both MOFCOM and the National Development and Reform Commission (NDRC) have pledged to "stabilize" FDI in light of the coronavirus emergency, as the outbreak is profoundly shifting the external environment for both inbound and outbound investment. Many countries are reconsidering their reliance on foreign sources of supply, particularly for critical and strategic goods, and investors in China—the biggest beneficiary of booming global FDI for three decades—are looking at supply chain diversification or even reshoring. Several Organization for Economic Co-Operation and Development (OECD) governments have tightened foreign investment screening in part to prevent opportunistic foreign investors from buying their assets at a discount as a result of COVID-19.

China continues to encourage portfolio inflows, and the Phase One deal allows U.S. firms to invest in asset management companies in the distressed debt market (at the provincial level, not nationally). After lifting restrictions on Qualified Foreign Institutional Investors (QFIIs) in late 2019, the People's Bank of China (PBOC) and State Administration for Foreign Exchange (SAFE) in May 2020 implemented regulations allowing foreign investors to engage in a wider range of onshore financial markets. The regulations simplify profit repatriation (no longer requiring a special audit report by a Chinese CPA), allow investors flexibility in choice of foreign currency, and make other technical improvements. These changes are timed to promote a better environment for portfolio inflows, showing Beijing is committed to encouraging inflows but in a controllable way.