CROSS-BORDER INVESTMENT

THE STORY SO FAR

China is deeply engaged with the global economy through trade links, but far less integrated with 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 RMB Qualified Foreign Institutional Investor, (RQFII)), 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.

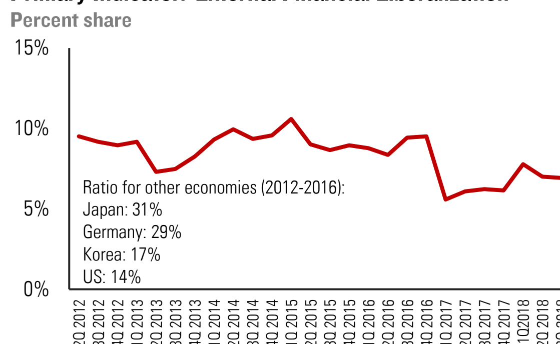
- Meanwhile, China has backpedaled on capital account reforms. In 2014 and 2015, Beijing relaxed rules for outbound FDI, but regulators reversed course after outflows soared, pressuring the balance of payments and the exchange rate. Controls on other capital outflows were also tightened, including outbound 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 is neutral this quarter. Our primary indicator of gross cross-border flows is almost unchanged at 6.9% (compared to 7% in the previous quarter, and against an average of roughly 14% for the United States and 31% for Japan) and remains well below the 9.2% average in 2015–2016. In other words, China is not becoming more open to capital inflows and outflows.

- Our data make clear that tight capital controls continue to restrict outflows, foreign investment is still significantly stifled by policy constraints despite new promises to open key markets, and the central bank continues to actively intervene in the foreign exchange market.

- Restrictions on capital outflows are likely to remain in place. However, Beijing did take steps to encourage more inflows during the review period by revising the Foreign Direct Investment Law and expanding quotas for foreign portfolio investment inflows.

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**. Our data show that cross-border flows normalized somewhat in 2018 but remain well below levels seen in advanced economies. After ticking up to 7.8% in 1Q2018, the ratio of cross-border capital flows to GDP dropped back to 7% in 2Q2018 and 6.9% in 3Q2018. In 3Q2018, gross cross-border capital flows (inflows plus outflows) were $231 billion. This is higher than the average quarterly flows

in 2017 ($189 billion) and similar to levels in 2014–2016 (a quarterly average of $251 billion).

Most concerning this quarter is that China maintained a modest financial account surplus, despite a sharp depreciation in the renminbi (RMB) during the period, which should have probably resulted in a financial account deficit, all else being equal. This likely results from far-reaching capital controls in place since 2016 that dilute reform objectives. China's non-reserve financial account posted a small surplus of $14 billion in 3Q2018, mostly due to a $34 billion surplus in the portfolio securities account (see **Net Capital Flows**). The net "other investment" balance was negative $20 billion, down from plus $54 billion in 2Q2018, likely because of new transaction costs imposed on foreign currency hedging by banks, and net direct investment was essentially zero ($0.07 billion) as inflows and outflows balanced each other out.

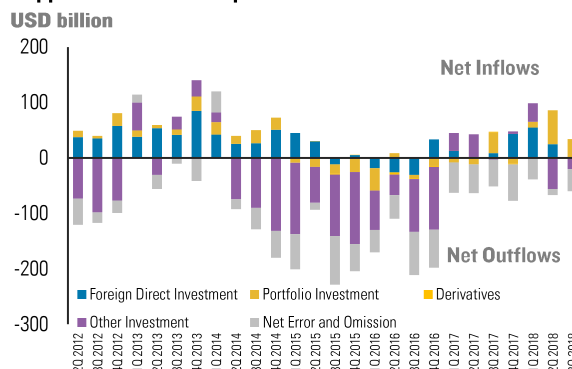
Foreign portfolio investment inflows were volatile, as foreign institutional investors took chances on Chinese investments only opportunistically when short-term factors lined up, a sign of low confidence in long-term liberalization of financial markets. After record inflows of $65 billion in 2Q2018, foreign portfolio investment dropped to $43 billion in 3Q2018 (see **Breakdown of Cross-Border Financial Flows**). Foreign sovereign (state-run) buyers such as the Russian central bank, rather than private institutional investors, drove some of these inflows.

After several strong quarters, foreign direct investment inflows also dropped, to just $25 billion (from a peak of $80 billion in 4Q2017), another sign of short-term financial considerations at work rather than optimism about new market opportunities. Relatedly, after a brief rebound earlier in the year, the share of foreign buyers in Chinese M&A activity edged down over the past two quarters, showing that recent liberalization steps (such as lower equity limits and joint venture requirements in certain sectors) have not triggered enough enthusiasm to pull foreign investors meaningfully into new acquisitions.

Finally, data make 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. China posted the first official drop in **Foreign Exchange Reserves** since 1Q2017 in the third quarter, totaling $3 billion. The change in total reserves held by the People's Bank of China (PBOC), China's central bank, as reported in its own data was also negative for the quarter. These two indicators confirm that the government sold reserves to defend the currency during the review period, as the PBOC resisted depreciation pressure more aggressively starting in August 2018.

Supplemental 1: Net Capital Flows

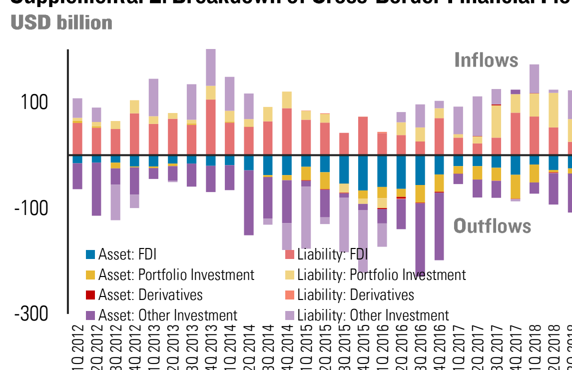
USD billion



Source: State Administration of Foreign Exchange.

Supplemental 2: Breakdown of Cross-Border Financial Flows

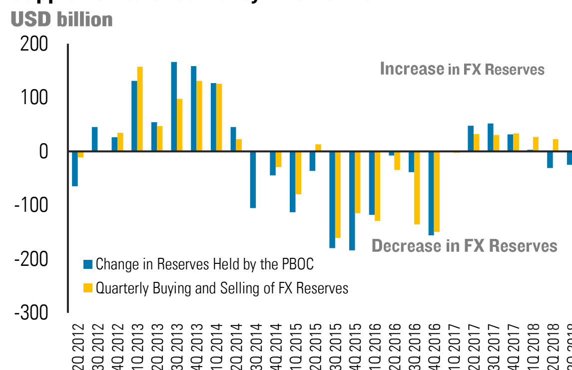
USD billion



Source: State Administration of Foreign Exchange.

Supplemental 3: Currency Intervention

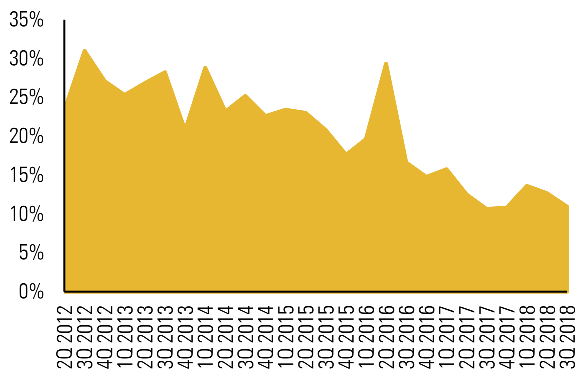
USD billion



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

Supplemental 4: Foreign Appetite and Market Access

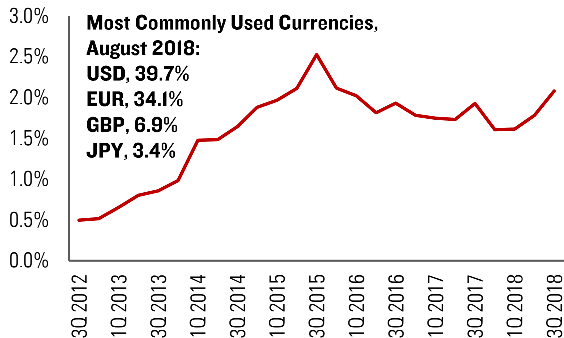
Percentage



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

Beijing's external capital flow policy involves controlling outflows while trying to expand and diversify inflows. Liberalization is happening gradually and mostly on the inbound side. This is unsustainable given China's need for openness to foreign investment and household and corporate diversification into foreign assets.

Controls on outbound capital remained tight against the backdrop of a weakening RMB and slowing domestic growth – both of which could promote capital flight. China's currency depreciated significantly against the U.S. dollar and other currencies starting in June, and officials are guiding interest rates lower to stimulate the economy. With tighter monetary policy and higher rates in the United States and elsewhere, conditions are ripe for capital outflows and pressure on China's balance of payments. The government defied expectations of a relaxation in outbound investment controls and maintained a tight grip throughout 2018. In early October, China reportedly started to suspend approvals of the Qualified Domestic Limited Partnership (QDLP) investment scheme, in order to control overseas investments. In late October, China tightened scrutiny of overseas investments by financial institutions using state-owned assets and imposed stronger reviews of the structure, funding sources, and investment targets of these companies.

On the inbound side, Beijing released new policies to improve market access and attract foreign direct investment. Most of these are not new ideas, but an acceleration of existing processes and symbolic steps. It is apparent that growing international pressure, particularly from the United States, resulted in measures to improve foreign market access. China demonstrated new willingness to implement previously announced foreign investment liberalization, especially in financial services and autos. For example, in 4Q2018 the China Securities Regulatory Commission approved UBS's application to hold a majority stake in its China securities joint venture, making UBS the first foreign-*controlled* brokerage in China. Tesla recently broke ground on its Shanghai plant, the first wholly foreign-owned auto factory in China. In addition, Beijing promised better intellectual property (IP) protection for foreign companies, and on December 26 the National People's Congress reviewed a new draft Foreign Investment Law, which will create a new FDI regime based on pre-establishment national treatment for foreign investors, limited only by a negative list and explicitly prohibiting local governments from requiring foreign investors to transfer technology in exchange for market access. These rhetorical commitments are welcome, but they will have to be implemented.

In regards to portfolio investment policy, Beijing announced in August that foreign investors would be exempt from paying income tax and value-added tax on their onshore bond investments for a three-year period. In September, FTSE Russell announced that it will add China's A-shares to its emerging markets index with a weighting of 5.5% starting in June 2019, and additional announcements of planned inclusions of Chinese assets into global bond and equity indices are expected to follow this year. To facilitate this, the Qualified Foreign Institutional Investor (QFII) program quotas were increased from $150 billion to $300 billion. However, this is a symbolic gesture, as the State Administration of Foreign Exchange (SAFE) had not allocated individual quotas approaching the previous $150 billion ceiling: the move itself will permit more inflows only if these firm-specific limits are adjusted.