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

![Graph showing annual percentage of cross-border investment flows under China's financial account](image)

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

- Our assessment remains negative this quarter. Gross cross-border capital flows as a percentage of GDP declined to the lowest level in the past decade, and capital inflows have not picked up substantially despite fewer FDI restrictions and China’s inclusion in global equity and bond indices.

- Data indicate that international use of China’s currency has not expanded, and capital controls remain intact, while the central bank continues to stabilize the exchange rate.
• The trade dispute with the United States is testing Beijing’s commitment to opening its financial sector. Despite new liberalization of inflows, broader structural impediments remain unchanged and other new policies add to uncertainty. Moreover, capital outflow restrictions remain tight.

This Quarter’s Numbers

China’s investment engagement declined in 1Q2019, with our primary indicator dropping to the lowest level of the last decade (see External Financial Liberalization). Gross capital flows in both directions picked up slightly, to $182 billion in 1Q2019 from $148 billion in 4Q2018, but as a proportion of China’s economy, they dropped to 5.74%. This is a disappointing result in light of China’s ostensible growing openness to international capital flows. By comparison, this ratio averaged 9.5% in China from 2011 to 2015.

Foreign investment in China’s financial markets appears to be motivated by short-term changes in interest and exchange rates, rather than long-term confidence in the regulatory and investment environment. Foreign portfolio inflows rebounded to $35.7 billion in 1Q2019 from $8.1 billion in 4Q2018 (see Breakdown of Cross-Border Financial Flows). These inflows were more concentrated in equities than in bonds, responding to an improved economic outlook in 1Q2019. Foreign inflows are poised to surge, but investors remain cautious despite increasing numbers of international equity and bond indices including Chinese assets.

FDI inflows—driven largely by corporations that are less sensitive to financial market conditions—remained at a similar level in 1Q2019 ($47.6 billion) as in 4Q2018, but Beijing’s efforts to boost foreign investment inflows by abolishing restrictions clearly have not translated into an FDI boom (see Breakdown of Cross-Border Financial Flows). The jump in the share of foreign-led mergers and acquisitions (M&A) to 20% in 1Q2019 from 15% in 4Q2018 was mostly a result of a sharp drop in total M&A activity in China (see Foreign Appetite and Market Access). As the overall volume of foreign M&A transactions actually dropped, the rise in foreign M&A value in 1Q2019 is not evidence of sustained improvement in China’s receptiveness to foreign acquisitions.

While inflows improved as a result of temporary factors in 1Q2019, capital outflow pressures remain high. Errors and omissions in China’s balance of payments, which reflect capital leaving the country not accounted for elsewhere, rose to $87.8 billion in 1Q2019 (see Net Capital Flows)—close to the record high for a single quarter. Although China’s currency strengthened modestly during the review period because of global macroeconomic conditions, currency intervention persisted at times—even after official assurances that exchange rates would be liberalized (see Currency Intervention). The central bank has continued intervening unilaterally, allowing some appreciation early in 2019 while resisting depreciation pressures through intervention. Even though depreciation is merited as China eases monetary policy, it is an irritant to Washington. Moreover, internationalization of the currency has not progressed: only 1.96% of international financial transactions used the renminbi in 1Q2019—basically unchanged since 2015 (see Globalization of China’s Currency).
**Policy Analysis**

Official messaging in early 2019 emphasized further liberalization of inbound direct and portfolio investment to balance hardwired capital outflows, but broad structural impediments remain unchanged and new policies add to uncertainty. Restrictions on outbound capital flows are as tight as before, if not tighter.

Following the approval of a new Foreign Investment Law at the annual National People’s Congress in March, China advanced a new negative list at the end of June, reducing inbound investment restrictions for additional sectors and shrinking the number of restricted sectors from 48 to 40. Foreign investments in shipping agencies, cinemas, performance agencies, and local gas and heating pipe systems no longer require a controlling domestic partner. Although this change is a step in the right direction, it does not advance opening in critical sectors that could attract significant inbound FDI, such as autos. Restrictions on the service sector continue to limit the scope of future FDI in China. The negative list was received as moderately disappointing in this regard.

Other new policies are problematic for foreign firms, particularly in industries with national security implications. In early June, the National Development and Reform Commission announced plans to establish a “national technological security management list system” to “more effectively forestall and defuse national security risks,” although it offered no details. China’s Cyberspace Administration released two measures—one on data security and another on exporting personal information—that could have an impact on businesses subject to ongoing follow-up regulations under the Cybersecurity Law. The State Council in June clarified
restrictions on foreign companies’ collection, storage, and sharing of genetic information from China.

Financial sector liberalization to attract foreign investment has been more promising in the past six months, particularly in banking. On May 1, the China Banking and Insurance Regulatory Commission (CBIRC) announced the removal of 20 percent and 25 percent equity limits on investments in individual banks or groups and a $10 billion asset requirement for foreign-invested banks, as well as the asset requirement to establish branch networks. In the securities business, UBS, JPMorgan, and Nomura were all approved for majority stakes in joint ventures, and Premier Li Keqiang explicitly vowed to remove all foreign equity restrictions for securities firms by 2020 in July at the World Economic Forum in Dalian. The CBIRC also promised on May 1 that foreign insurance companies will be allowed to invest in already foreign-invested insurance firms, while regulators also removed asset requirements attached to foreign insurance brokerages operating in China. On July 20, it was also announced that foreign ownership caps for insurance companies would be lifted by 2020.

China-issued bonds and equities are gaining more international exposure. On April 1, China government and policy bank bonds were added to the Bloomberg Barclays Global Aggregate Bond Index; after implementation (20 months), Chinese assets will account for around 6% of the global index. Chinese equities were introduced to the MSCI Emerging Markets Index in June 2018 and to the FTSE Russell Emerging Markets index in June 2019. So far, most portfolio inflows into China’s financial markets appear to be more actively managed, meaning they could reverse in response to changing macroeconomic conditions—in contrast to more stable passive flows tracking the performance of major bond indices.

While inflows have become more responsive to temporary conditions than to sustainable, liberalization-driven investor confidence, controls on outbound capital flows remain tight, even if they are not always effective. Former People’s Bank of China advisor Yu Yongding, a longtime proponent of capital controls, even complained publicly that a bank had refused his attempted conversion and transfer of $20,000 abroad—less than the $50,000 annual quota for individual foreign exchange transfers. Capital controls have worked when applied narrowly (e.g., to outbound FDI transactions), but the strong volume of errors and omissions-related outflows suggests they remain quite porous even as Beijing attempts to tighten control.

Exchange rate liberalization remains at a crossroads. Political machinations to control the currency discourage inflows since they introduce more uncertainty and fail to follow economic logic. How much exchange rate flexibility Chinese authorities permit—in both directions—will be a key indicator of China’s commitment to cross-border investment policy reform, especially as the trade dispute with the United States intensifies.