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

![Chart showing external financial liberalization ratio for other economies (2012-2016): Japan: 31%, Germany: 29%, Korea: 17%, US: 14%)

- Our assessment remains negative this quarter. Gross cross-border capital flows as a percentage of GDP declined to new lows, and speculative capital outflows have picked up relative to portfolio capital inflows as China’s currency has depreciated.

- Foreign acquisitions are declining amidst a broader drop in mergers and acquisitions (M&A) activity, indicating weakening foreign appetite for longer-term investments in China.
• Commitments to remove foreign equity caps on asset management firms and securities firms have clear timelines for 2020. Overall, investment opening is primarily focused on encouraging inflows rather than two-way cross-border transactions.

This Quarter’s Numbers

China’s financial system continues to rely on domestic investment, rather than increasing engagement with international capital markets. Cross-border capital flows continued declining as a proportion of China’s economy in 2Q2019, reaching a record-low level of 4.26% of GDP (External Financial Liberalization). Both inflows and outflows trended lower relative to the size of the economy this quarter, highlighting the limits to implementing liberalization promises so far, and the urgency of doing so.

The outflows that are persistent appear to be primarily speculative in nature, consistent with the 2Q2019 depreciation of the currency after trade tensions escalated in May. Companies and households are still trying to get money out of China: errors and omissions under the balance of payments, which capture “hidden” outflows outside legal channels, showed an astonishing $241.6 billion in outflows over the past four quarters, a new record (see Net Capital Flows). In addition, foreign equity investment reported a net $14.1 billion outflow in 2Q2019, the first outflow since the stock market crash in the second half of 2015 and the largest-ever quarterly outflow from China’s equity markets.

While official foreign reserves did not decline (see Currency Intervention), the central bank has intervened to resist rapid currency depreciation through less obvious channels, primarily by encouraging Chinese banks to borrow U.S. dollars abroad. Major tightening of capital controls to temporarily slow outflows would likely increase market fears about China’s financial stability and pressure the currency to depreciate further. Internationalization of China’s currency has not advanced, in part because of continued concerns about the imposition of capital controls: only 1.94% of international financial transactions used the renminbi in 2Q2019 – basically unchanged since 2015 (see Globalization of China’s Currency).

Despite policymakers efforts to attract portfolio inflows, Chinese investors sent more money into overseas financial markets, while inflows from foreign investors shrank. Portfolio investment reported a smaller surplus ($3.6 billion) in the second quarter than in 1Q2019 ($19.5 billion), lower than the 2018 average (see Breakdown of Cross-border Financial Flows). Bond inflows did pick up strongly to $39.5 billion, but this still may be a response to China’s weakening economy (that is – betting on more stimulus) rather than longer-term factors such as the inclusion of Chinese securities within the Barclays Bloomberg Global Aggregate Index starting in April.

FDI inflows are unpredictable at present, falling to $34.3 billion in 2Q2019 from $47.6 billion in the first quarter, eroding China’s surplus. In 2Q2019, while overall M&A deal flow picked up, the foreign-involved share decreased from 20% last quarter to 13% this quarter (see Foreign Appetite and Market Access). Recent efforts to abolish equity caps and allow greater foreign equity ownership in certain industries do not seem to have a meaningful impact yet on foreign deal making in China.

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.
Policy Analysis

China's need to attract capital inflows has influenced both financial sector opening and People's Bank of China (PBOC) rhetoric. In late September, in a press conference ahead of the 70th anniversary of the People's Republic of China, PBOC Governor Yi Gang commented that China should “cherish the scope of normal monetary policy” while other global central banks were easing to cement its position as “the highlight of the global economy and one the market should admire.” This is unusually direct language, essentially calling for additional capital inflows by comparing China’s monetary policy trajectory with that of other central banks and suggesting that Yi understands the importance of attracting significant capital inflows.

To foster needed inflows, Chinese authorities have offered timelines for financial sector liberalization steps. The securities regulator announced China will scrap foreign ownership limits on futures companies starting on January 1 of next year and on fund management firms starting April 1, 2020. Securities companies will see equity caps scrapped starting December 1 of next year. These are positive, concrete steps following through on earlier promises of liberalization, but the critical issue remains whether or not they will actually encourage inflows and additional investments in these sectors, given the broader change in the political climate surrounding China’s relations with the rest of the world, and the trade dispute with the United States in particular. A few foreign majority stakes in securities joint ventures have been approved, but the operating environment for wholly foreign-owned and operated enterprises in these sectors remains untested.

China continued to advance measures aimed at improving the domestic business environment for foreign investors in mid-2019. In October, Beijing circulated a draft version of the FDI law implementation measures, which received a positive response from the foreign business community. The State Council also reaffirmed several commitments to improving the domestic environment for FDI in October 2019. Premier Li Keqiang reiterated during a State Council regular meeting that China will continue to open up to foreign investment, promote ease of investing, protect foreign investor interests, and strengthen investment promotion on the local level. The actual impact of these efforts on FDI inflows will depend on whether the final implementation and enforcement details can meaningfully improve the business environment and boost foreign investor confidence after the new FDI law goes into effect on January 1, 2020.

Inflows continue to materialize, but portfolio inflows in particular areas are at risk of reversing unpredictably. While China is being included in additional bond indices,
such as JP Morgan’s GBI-Emerging Markets index (at the 10% level, expected to begin at the end of February 2020), the FTSE Russell recently declined to include Chinese securities within its primary bond index, citing concerns about market liquidity and foreign exchange clearing and hedging instruments.

Attracting additional inflows is now critical for China. Capital outflows have intensified, shown by the record volume of errors and omissions-related outflows over the past year. China’s central bank must gradually withdraw from intervening to defend the currency over time to allow both exchange rates and interest rates to become more responsive to market forces. On the one hand, the currency faces fundamental pressures to depreciate, and a more market-driven exchange rate will make investment in China more attractive. On the other, the pace and timing of that depreciation could be perceived as retaliation in the trade dispute, fueling concerns about political control of the exchange rate that would discourage foreign investment. Thus, in motivating inflows, the PBOC faces a delicate calculation: how much exchange rate flexibility it can permit versus how that flexibility is perceived by investors.

The growing political divide between China and the rest of the world may become a significant influence on those flows over time, particularly if market-driven investors start to see negative political costs attached to both direct investments in China and portfolio investments in Chinese securities. This concern is particularly relevant given the political crisis in Hong Kong and Beijing’s growing threat to the independent legal and institutional environment in the city, since many of China’s portfolio inflows via the Bond Connect and Stock Connect programs flow through Hong Kong, and the city reflects a significant channel for wholesale borrowing by Chinese banks as well. In November, a bipartisan group of members of the U.S. Congress introduced legislation to block government pension funds from investing in Chinese stocks. At present, however, there seems to be little momentum behind impeding U.S. outflows into Chinese assets.