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 unchanged at slightly negative for 1Q2020. The primary indicator improved, but only because the economy shrank more than capital inflows under COVID-19.

- Both foreign direct investment and portfolio inflows decreased considerably in 1Q2020 due to the COVID-19 shock. However, a global U.S. dollar funding squeeze likely caused Chinese authorities to sell USD assets, which led to net capital inflows in the quarter—a reversal of the previous trend. This change is likely to be temporary.

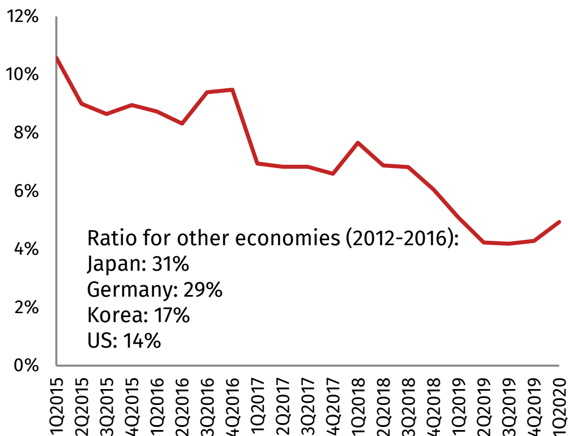
- Beijing doubled down on its efforts to encourage foreign investors to stay in China by reducing restrictions and acknowledging the need to end unequal treatment.

This Quarter's Numbers

The ratio of two-way capital flows to GDP increased to 4.93% in 1Q2020, up from 4.29% in 4Q2019, the biggest quarter-over-quarter improvement in our primary indicator in two years (see **External Financial Liberalization**). But the reason for the increase is that GDP contracted more than capital flows in the period. The reading remains significantly lower than the 9% registered by China in 2014, and far below the levels seen in advanced economies like the United States (14%), Germany (29%), and Japan (31%).

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.

The COVID-19 crisis triggered a surprising shift in the net capital flows balance for the first time in six years: inflows instead of outflows in 1Q2020 (see **Net Capital Flows**). Global U.S. dollar market movements were responsible for this. As banks and companies hoarded dollars to repay debts and keep business going during the pandemic, high demand created a global dollar funding squeeze. In response, Beijing's State Administration of Foreign Exchange (SAFE) and many state-owned enterprises (SOEs) appear to have repatriated foreign capital to meet dollar-funding demand from domestic borrowers.

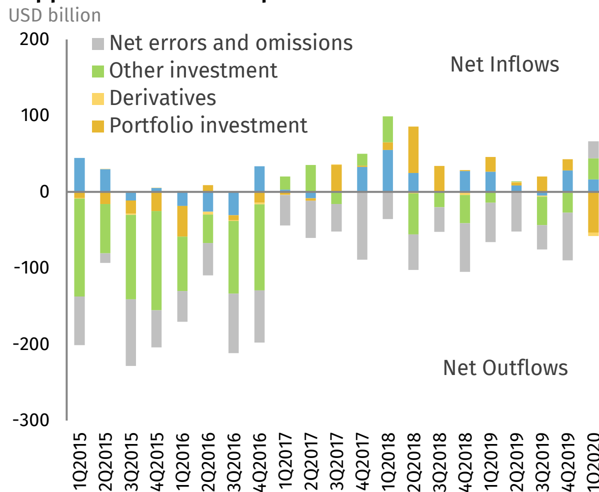
These machinations effected exchange rate pressures: China's central bank intervened to slow the yuan's decline in March and to moderate its subsequent appreciation in June. As a result, China's foreign exchange reserves saw the largest single-quarter decline since 3Q2017, falling $47.3 billion in 1Q2020 (see **FX Reserves**). Since the COVID-19 pandemic began, the central bank has managed the currency more directly against the U.S. dollar, as opposed to a basket of currencies, which is a step backward for exchange rate flexibility.

Despite much discussion about reducing dependence on the U.S. dollar, renminbi (RMB) internationalization increased only slightly. RMB-denominated global payments accounted for 1.87% of global transactions by value in 1Q2020, up from 1.84% in 4Q2019, a trivial increase (see **Globalization of China's Currency**). The RMB remained the fifth most active currency in international payments as of March 2020.

The share of foreign participation in China's domestic mergers and acquisition (M&A) activities increased to 18% from 12% (see **Foreign Appetite and Market Access**). The number of foreign-involved transactions was on par with typical first quarter levels, but the total number of transactions decreased considerably, resulting in a rising share for foreign-involved deals.

Supplemental 1: Net Capital Flows

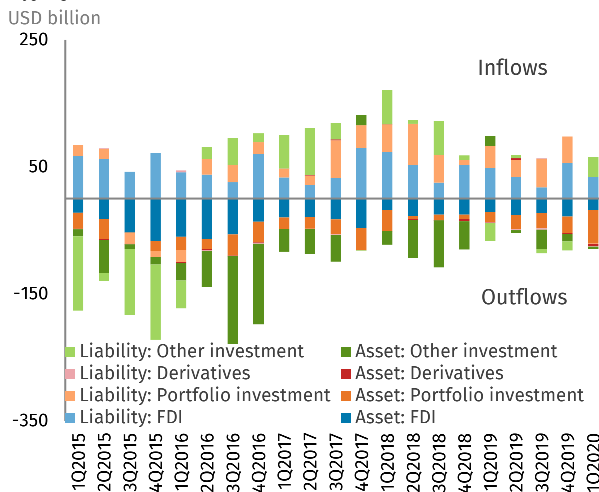
USD billion



Source: State Administration of Foreign Exchange.

Supplemental 2: Breakdown of Cross-Border Financial Flows

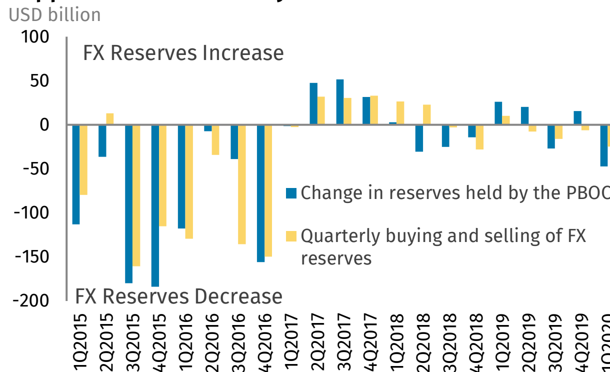
USD billion



Source: State Administration of Foreign Exchange.

Supplemental 3: Currency Intervention

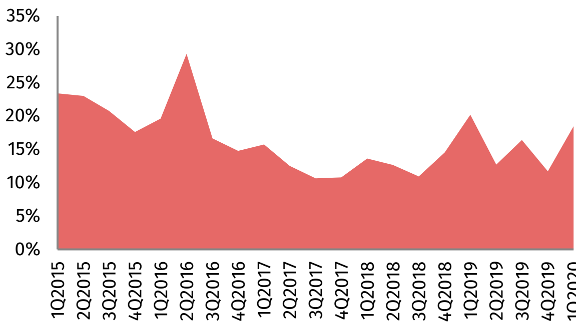
USD billion



Source: State Administration of Foreign Exchange, Rhodium Group.

Supplemental 4: Foreign Appetite and Market Access

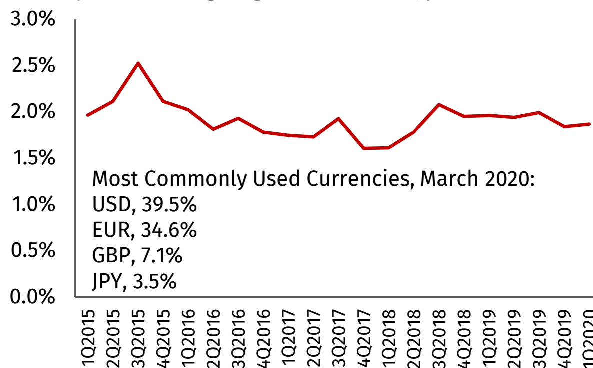
Share of deals with foreign buyers in total number of acquisitions with Chinese target, percentage



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

The COVID-19 pandemic has pushed foreign firms and governments to reconsider their future with China. Foreign investment has long played a crucial role in China's economy; in the first half of 2020, Beijing took steps to encourage foreign investors to stay rather than hedge their China bets. Those foreign firms are canaries in the Chinese coal mine. Beijing needs the world to see them thriving, and to see RMB internationalization moving forward to prove that sanctioning China over its authoritarian crackdown in Hong Kong, Xinjiang, and elsewhere will not stymie its rise, and that China's dependence on the U.S. dollar system does not constrain it.

To make a case for China's inexorable globalization, Beijing took other steps as well. On May 7, authorities lifted quota limits on foreign portfolio investment through the Qualified Foreign Institutional Investors (QFII) and RMB Qualified Foreign Institutional Investors (RQFII) programs. Ending these limits was intended to promote foreign investor inflows, but COVID-19 interrupted that. Foreign investors did not view China as a safe haven during the crisis and needed to liquidate securities quickly, producing a significant net outflow (USD 53.2 billion) under China's portfolio securities account—the largest in this component in history. Inflows returned in 2Q2020, offsetting much of the first quarter outflow, but the outlook is murky.

On June 26, the National Development and Reform Commission (NDRC) and the Ministry of Commerce released the updated "Special Administrative Measures on Access to Foreign Investment," which reduced the number of restricted industries to 33 from 40. Most of the changes had been flagged beforehand. These included a reduction in foreign ownership restrictions in the securities, investment fund management, futures, and life insurance sectors, as well as a lifting of the foreign ownership cap in commercial vehicle manufacturing.

A July 29 State Council Executive meeting reemphasized the importance of stabilizing foreign investment. The State Council stressed the importance of ensuring equal financing support for foreign-invested companies, including refinancing and new loans from the Import-Export Bank. Similar language on eliminating unequal treatment for foreign firms can be found in the July 12 State Council "Guidance on Stabilizing Foreign Trade and Investment." This included a pledge to facilitate travel for "qualified foreign business executives," suggesting that the government is keen to have foreign companies resume normal operations even as COVID-19 restrictions remain in place.

Continued U.S. monetary easing has drawn criticism from Beijing about the long-term stability of the dollar and valuation of dollar-denominated assets. Fang Xinghai, vice chairman of the China Securities Regulatory Commission (CSRC), argued in June that China would need to accelerate RMB internationalization to reduce its exposure to valuation risks from USD-denominated assets. Fang also implied that rising political tensions between China and the United States have made China's dependence on the USD payment system a security risk.

China will not be able to significantly increase the offshore use of its currency in the short term. As noted above, RMB usage is far lower that of other international currencies, and there has been limited action to promote it in 2020. China's persistent trade surpluses limit the RMB's overseas circulation, and capital outflows remain subject to regulatory controls. Recent rhetoric highlighting the need for RMB internationalization is likely a response to the threat of sanctions from the United States, related to Hong Kong and Xinjiang, rather than a sign that China is setting new policy priorities.