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

- We upgrade our assessment of reform in cross-border investment as capital flows increased in both directions in 2Q2020.

- China attracted stronger portfolio inflows in 2Q2020 because its economy has recovered faster than expected from the effects of COVID-19 lockdowns, with the lure of positive real interest rates and yields increasing global appetite for Chinese assets, despite a recent wave of defaults in China's corporate bond market.

- Authorities have made more promises of capital account liberalization, and conditions are now favorable for liberalizing outbound flows. However, this is a reform objective that has not yet been met.

This Quarter's Numbers

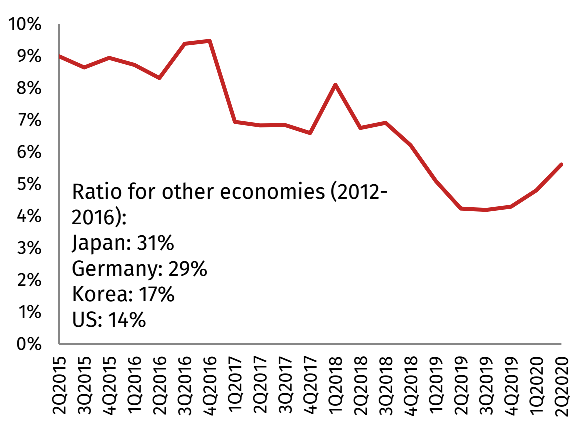
Investment openness improved this quarter. In 2Q2020, cross-border capital flows increased in both directions and as a proportion of China's economy, compared with the prior quarter. Our primary indicator (**External Financial Liberalization**) shows that the ratio of capital flows to GDP rose to 5.61% in 2Q2020 from 4.80% in 1Q2020, the third consecutive quarterly increase. However, this is partly a result of the contraction in China's GDP earlier this year. The ratio remains far below those of advanced economies.

Capital flows into China rose in 2Q2020 as financial markets stabilized and as the Federal Reserve eased US dollar funding conditions in April. In the first quarter, private investors reacted to the COVID shock by withdrawing investment from China, particularly from the equity market, and seeking safer havens abroad. In 2Q2020, private inflows returned to China's bond and equity markets. As a result, China posted one of its largest portfolio securities inflows in history at $42.4 billion (see **Net Capital Flows**). (Strong inflows into the bond market continued in 3Q2020, but stock market flows have since reversed.)

Although the small $19.1 billion increase in China's foreign exchange reserves in 2Q2020 suggests the People's Bank of China (PBOC) did not intervene significantly to manage the exchange rate, it is likely that there was an indirect intervention to limit the currency's appreciation (see **FX Reserves**). The PBOC can do this by instructing state banks to purchase foreign exchange on its behalf. In the second quarter, China was facing strong inflows from trade surpluses and portfolio flows, which would have pressured the RMB to appreciate and kept capital outflows minimal. The reported high level of capital outflows in 2Q2020 is not consistent with minimal foreign exchange intervention. Hidden intervention of this kind is a backward step for exchange rate reform, though it may be temporary, as the PBOC has appeared to stop intervening in 3Q2020.

Primary Indicator: External Financial Liberalization

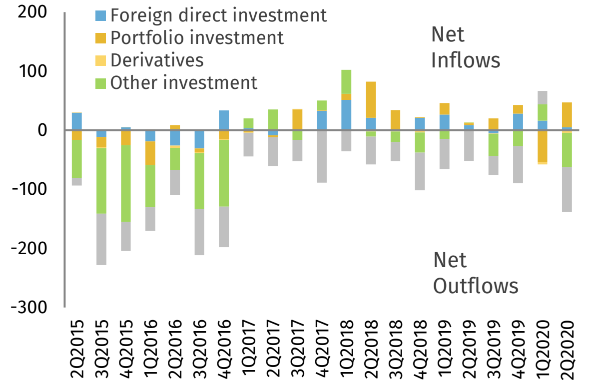
Gross sum of cross-border investment flows under China's financial account (excluding reserves) as a share of GDP, year to date, percent



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

Supplemental 1: Net Capital Flows

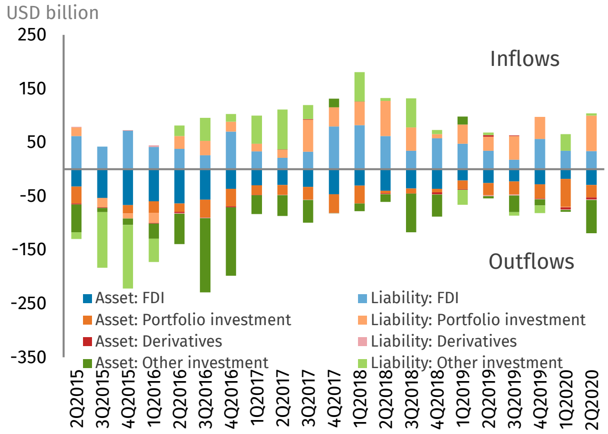
USD billion



Source: State Administration of Foreign Exchange.

Supplemental 2: Breakdown of Cross-Border Financial Flows

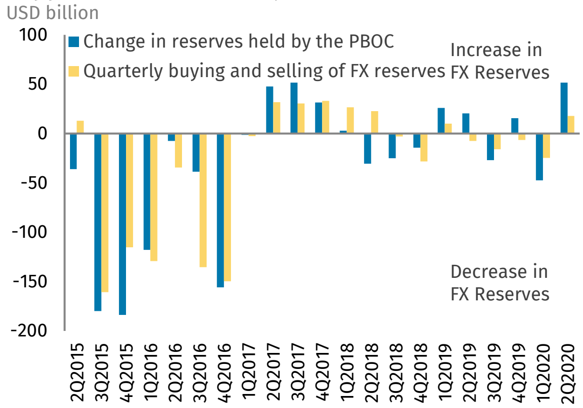
USD billion



Source: State Administration of Foreign Exchange.

Supplemental 3: Currency Intervention

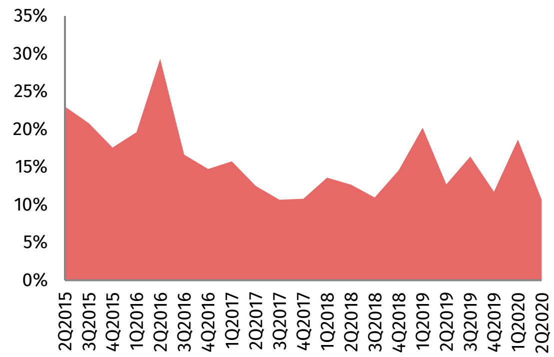
USD billion



Source: State Administration of Foreign Exchange, Rhodium Group.

Supplemental 4: Foreign Appetite and Market Access

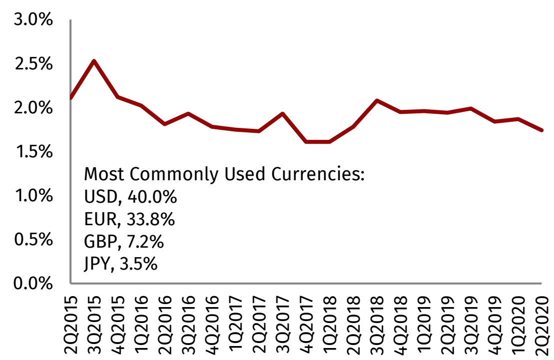
Share of deals with foreign buyers in total number of acquisitions with Chinese target, percentage



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

Authorities took small steps to liberalize foreign direct investment (FDI) inflows and talked seriously about loosening controls on outbound investment.

Following the release of a shorter FDI *Negative List* and draft measures reducing administrative barriers to foreign acquisitions of Chinese companies in June, China announced new steps to improve foreign investor access. On October 11, the State Council unveiled a comprehensive 2020–2025 pilot plan for reforms in Shenzhen, the southern special zone city paired with Hong Kong. The plan aims to "optimize the business environment" by promoting openness and fair competition. Shenzhen will further relax restrictions in energy, telecoms, public service, transport, and education, while opening up the financial services and shipping industries. This is all well and good, but why does all of this still need doing – on just a "pilot" basis no less – 42 years into the "reform and opening" era?

Coupled with relatively favorable conditions in light of the rest of the world still reeling from the COVID-19 pandemic, China's past opening efforts have succeeded in expanding cross-border capital flows, particularly for portfolio inflows. The rise in inflows has created a window of opportunity for regulators to do what they have not done so far — liberalize channels for capital outflows. The first step taken in early October was to reduce the reserve requirement on foreign exchange forward transactions to zero, reversing an action taken in August 2018 when the RMB was under pressure to depreciate. Following this, the State Administration of Foreign Exchange (SAFE) also expanded quotas for outbound portfolio investment by $10 billion.

In addition, financial technocrats are sounding more positive about capital account liberalization and exchange rate liberalization overall. PBOC Governor Yi Gang said in late October that the regulator's main job was to "reduce restrictions on the cross-border use of the currency, and let it take its own course." After five years of restricting outbound capital flows due to concerns about the possibility of losing control of China's currency, this is a notable shift in approach and a positive signal for investment opening.

The exchange rate fluctuated more in 3Q2020, with authorities allowing market forces more sway. The RMB appreciated from 7.06 per dollar at the end of 2Q2020 to around 6.60 per dollar by early November, a sharp appreciation by historical standards. At the same time, however, there are indications that the PBOC is trying to manage the currency indirectly by pressuring state banks to purchase US dollars on the central bank's behalf, which should tend to weaken the value of China's currency (see above).

Final Dashboard Assessment

Looking back, Beijing has made progress in inbound FDI reform since 2013. China moved from an approval-based system to a more liberal negative list-based approach and has gradually reduced the number of restricted sectors. After years of wavering, Beijing advanced outbound capital account reforms modestly by reducing quotas, but that does not mean much until it is symmetric, and outbound financial account opening is introduced in the same degree.

China's present stability relative to the world economy presents an opportunity to make good on 2013 pledges to liberalize the capital account and cross-border investment flows. But the fundamental reforms that have proven too challenging the past seven years are no less daunting today: in fact, years of deferral has made them more difficult. The exchange rate regime is barely altered: PBOC says market forces Looking back, Beijing has made progress in inbound FDI reform since 2013. China moved from an approval-based system to a more liberal negative list-based approach and has gradually reduced the number of restricted sectors. After years of wavering, Beijing advanced outbound capital account reforms modestly by reducing quotas, but that does not mean much until it is symmetric, and outbound financial account opening is introduced in the same degree.

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