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POLICY BRIEF

20-17 China's Financial Opening Accelerates

Nicholas R. Lardy and Tianlei Huang

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Despite predictions by some observers that the United States and China are headed for a "decoupling," China's integration into global financial markets is accelerating. Regulatory reform has opened China's financial market to many US and other foreign financial institutions. Foreign ownership of onshore Chinese stocks and bonds is growing rapidly and is likely to continue to expand in 2021. And inbound foreign direct investment (FDI) is on track to hit a new record in 2020. This integration is very asymmetric, however. China retains relatively tight control over both outbound direct investment and outflows of portfolio capital. US efforts to roll back the trend of deepening financial integration by threatening to delist Chinese companies traded on US markets and prohibiting any US investment in 35 Chinese companies that the Department of Defense alleges to be linked to the Chinese military appear to be largely symbolic.

Nicholas R. Lardy is the Anthony M. Solomon Senior Fellow at the Peterson Institute for International Economics. **Tianlei Huang** is research fellow at the Peterson Institute for International Economics.

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CHINA'S EASING OF REGULATIONS RESTRICTING FOREIGN OWNERSHIP OF FINANCIAL FIRMS

The best example of China's deepening integration into global financial markets is the substantial increase in the role of US and other foreign financial institutions in China, made possible when Chinese market regulators, starting in 2017, gradually eased long-standing restrictions on foreign ownership, most of which were incorporated into the US–China Phase One agreement signed in January 2020. Historically, foreign financial firms were largely restricted to operating in joint ventures with a minority ownership stake—meaning that in most cases, the Chinese partner had ultimate control over the enterprise. Recent liberalization has led to a substantial increase in the number of majority and wholly foreign-owned financial institutions operating in China, including many US institutions.

The attraction of the Chinese financial market for foreign firms is substantial and will only grow. The total assets of China's financial sector at the end of the second quarter of 2020 stood at RMB340 trillion ($48 trillion).[1] Because of previous restrictions, foreign firms have only a tiny slice of most segments of this

1 Based on exchange rate as of June 30, 2020.

market; they control less than 2 percent of banking assets, for example, and less than 6 percent of the insurance market.[2] Given the large size of China's domestic financial industry, if foreign firms can increase their shares in these market sectors, they stand to generate large profits. Doing so will be far from automatic, however, as Chinese financial institutions have built up strong positions in many of these markets.

China's regulators have allowed some US financial institutions to gain majority ownership of existing joint ventures and licensed other firms to access the Chinese market for the first time. These developments are consistent with the commitments China made in the Phase One agreement with the United States:[3]

China's regulators have allowed some US financial institutions to gain majority ownership of existing joint ventures and licensed other firms to access China market for the first time.

- In 2019, PayPal acquired a 70 percent stake in the Chinese firm GoPay, making it the first foreign company to provide online payment services in China. The deal allows PayPal to compete in the rapidly growing global mobile payments market, forecast by the market research firm Frost & Sullivan to reach almost $100 trillion in 2023.[4]
- In March 2020, Morgan Stanley was allowed to increase its ownership stake in its joint venture securities firm, Morgan Stanley Huaxin Securities Co., from 49 percent to 51 percent. At the same time, Goldman Sachs received approval to increase its 33 percent minority stake in its joint venture securities firm, Goldman Sachs Gao Hua Securities Co., to a 51 percent (majority) share. In December 2020, Goldman completed an agreement with its partner to acquire all outstanding shares of the joint venture. The agreement paves the way for Goldman to become the first wholly foreign-owned securities firm in China.
- In January 2019, JP Morgan Asset Management won approval from Chinese regulators to sell two Hong Kong–based funds on the mainland through its local joint venture, China International Fund Management. JP Morgan applied to assume full control of this asset management firm. In June 2020, it received approval to operate a new, wholly foreign-owned futures firm.
- In June 2020, American Express received approval to be the first foreign credit card company to launch onshore operations in China, through its joint venture with a Chinese fintech firm. The deal will allow it to conduct network clearing operations. Visa and Mastercard have also applied for network clearing licenses.
- In August 2020, Chinese regulators authorized BlackRock to operate a wholly foreign-owned mutual fund business.
- In September 2020, regulators approved Citibank's application to become the first US custody bank in China, allowing it to hold securities on behalf of fund managers.

2 Bloomberg, "China Will Scrap Securities Firm Ownership Limits by 2020, Li Says," July 1, 2019.

3 Whether China lives up fully to its Phase One commitments on financial liberalization is much harder to ascertain than is its commitment to increase imports from the United States by $200 billion in 2020-21. It is clearly moving in that direction, but more time and research are needed to verify the extent of China's implementation of the full range of its financial commitments.

4 Frost & Sullivan, "Mobile Payments Market in China Is Expected to Witness Three-Fold Growth with Doubling of Active Mobile Payment Users by 2023," January 4, 2019.

- In 2019, S&P Global set up a wholly foreign-owned firm that is the first company licensed to conduct credit-rating services in China's domestic debt market. In May 2020, Fitch's wholly foreign-owned subsidiary was approved to rate China's onshore issuers, including banks, nonbank financial institutions, and insurers and their bonds.[5]

REASONS FOR INCREASES IN CROSS-BORDER CAPITAL FLOWS INTO CHINA

In addition to the increased presence of majority or wholly foreign-owned financial institutions, China's integration into global financial markets is reflected in growing cross-border capital inflows of not only FDI but also of portfolio capital. Foreign ownership of onshore Chinese stocks and bonds reached RMB5.7 trillion ($837billion)[6] by the end of September 2020, a nearly eightfold increase over January 2014 (figure 1).[7]

China's integration into global financial markets is reflected in growing cross-border capital flows of not only FDI but also of portfolio capital.

Multiple factors have driven the rapid increase in foreign holdings of onshore renminbi-denominated Chinese securities:

- the rapid expansion of these markets, which makes them too big for global investors to ignore
- the increase in the number of channels for foreign portfolio investment to flow into China
- the inclusion of Chinese securities in global stock and bond indices that drive much institutional investing through passive funds that track them
- liberalization that allows foreign investors greater access to hedging instruments
- higher interest rates on Chinese corporate and sovereign bonds
- appreciation of the renminbi
- China's reemergence since the second quarter of 2020 as the world's fastest-growing economy.

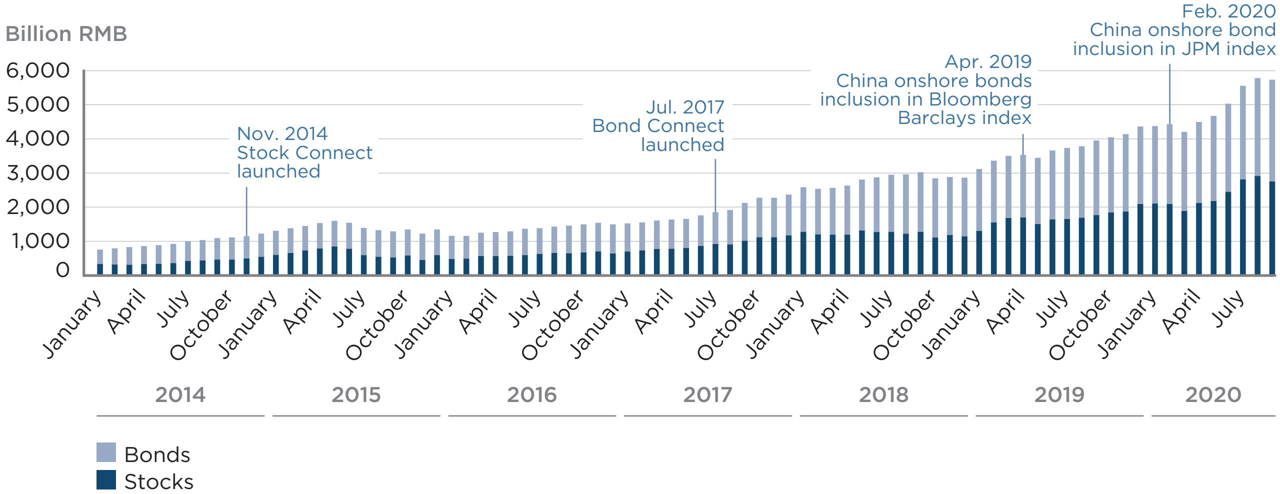
This Policy Brief examines each of these factors.

5 For a more comprehensive list that includes many non–US financial institutions that have gained greater access to China's financial market, see Bloomberg, "China's Finance World Opens Up to Foreigners, Sort of," January 22, 2020, updated December 6.

6 For the rest of this Policy Brief, the exchange rate used to convert renminbi to US dollars is as of September 30, 2020.

7 Foreign holdings of Chinese securities in offshore markets are substantially greater than in onshore markets. They are not analyzed here.

Figure 1
Foreign onshore portfolio investment in China, 2014–20



Source: People's Bank of China via Wind.

Rapid Expansion and Huge Size of the Chinese Market

The size of China's domestic bond market has exploded since 2015 (figure 2).[8] Although still modest compared with the US market, it overtook Japan's bond market in late 2018, making it the second-largest bond market in the world.[9] By the end of September 2020, the market stood at RMB114 trillion ($16.7 trillion). Foreign ownership of government bonds increased to account for about 9 percent of the market,[10] but the share is less than two-thirds of the foreign ownership share of government bonds in other Asian markets.

Compared with their holdings of government bonds, foreign investor holdings of Chinese corporate bonds are miniscule. The share is low not because the corporate bond market is small: At 22 percent of the total domestic bond market, it is much larger than the 16 percent share of central government bonds. As Chinese agencies rate 95 percent of domestic corporate bonds AA or higher (compared with 6 percent for bonds traded in the United States), foreign investors regard Chinese ratings of corporate bonds with suspicion and as a result hold only a tiny slice of China's corporate bond market (Schipke, Rodlauer, and Zhang 2019).

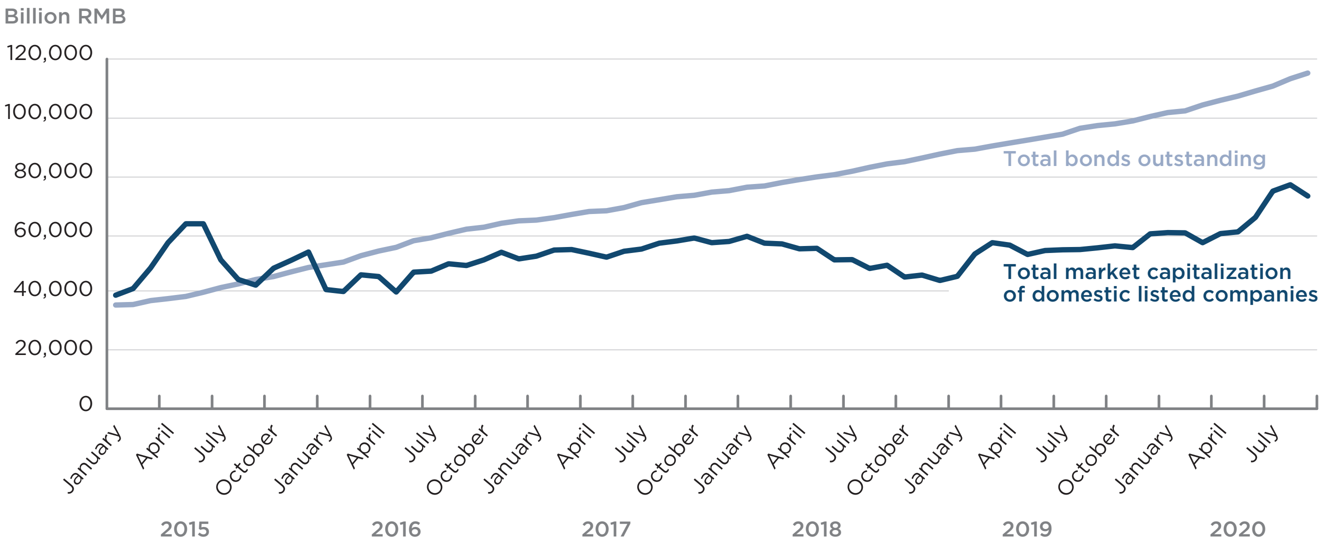
This share is likely to rise for two reasons. First, the increase in bond defaults in 2019–20 includes some firms rated as AAA by domestic rating agencies, presumably putting pressure on Chinese rating agencies to step up their game. Second, more and more Chinese corporates are expected to request ratings by foreign agencies, presumably providing foreign investors with better information. The uptick in corporate bond defaults in 2019–20 is not likely to slow the inflow

8 All data presented in this policy brief on the size of China's domestic financial markets is exclusive of Hong Kong markets.

9 See Hayden Briscoe, "China Bonds: Investing Opportunities in a Negative Yielding World," UBS Asset Management, October 14, 2019.

10 Thomas Hale and Hudson Lockett, "FTSE Gives China Bonds Green Light for Influential Index," *Financial Times*, September 24, 2020.

Figure 2
Size of China's domestic bond and equity markets, 2015–20



Note: Bond data include bonds issued by the Ministry of Finance, local governments, corporates, and financial institutions as well as collateralized loan obligations and negotiable certificates of deposit.

Source: People's Bank of China and China Securities Regulatory Commission via Wind.

of foreign investment into the Chinese bond market; foreign investors have long given China's corporate bond market a wide berth. Recent defaults only confirm their prior judgment.

China's domestic stock market has also grown rapidly. Its equity market cap exceeded that of Japan in 2014, making it the world's second-largest market. Further expansion pushed its market capitalization to RMB72.2 trillion ($10.6 trillion) as of the end of September 2020.

These markets are likely to continue to expand, because the government is actively supporting a shift in corporate funding away from bank credit toward direct funding (stocks and bonds). In March 2020, it supported this shift by announcing registration-based issuance of corporate bonds, replacing what had been a cumbersome bureaucratic approval process. An increasing number of domestic corporates are responding by announcing their intention to seek ratings from international credit rating agencies, paving the way for increased foreign ownership of corporate bonds.[11]

11 Data from the UBS Evidence Lab's February 2020 survey of Chinese corporates indicate that about 72 percent of respondents intended to obtain a credit rating from an international rating agency within the next 12 months, up from 33 percent in the previous survey, and 92 percent of respondents intended to do so within the next 24 months, up from 66 percent. See Kevin Chu, "Will Opening of a Potential $35 trn China Bond Market Support Growth in Global Financials?" UBS, September 7, 2020.

Gradual Widening and Deeping of Opening for Foreign Investors

The initial channel for foreign portfolio investment, the Qualified Foreign Institutional Investors (QFII) program, launched in 2002, was quite limited. To be eligible to participate in this market, foreign institutional investors had to meet strict requirements that included at least five years of asset management experience and a minimum of $5 billion in assets under management. Initially, both the range and the magnitude of securities available to foreign investors was limited. Most important, China set an aggregate quota on foreign investment allowed through this channel, with each licensed foreign investor assigned a slice of it. In addition, foreign investors were allowed to repatriate no more than 20 percent of their investments per month, reducing the interest of foreign fund managers in onshore Chinese portfolio investment.

Over time, regulators lifted or eased many of these restrictions. In 2012, they raised the quota for the QFII program from its initial level of RMB30 billion to RMB80 billion. In June 2018, they eliminated the limits on repatriation of investment funds. In October 2019, they eliminated all quota restrictions in the QFII program. Later, they simplified procedures for transferring funds into China and repatriating investment income.

The regulatory authorities also expanded foreign access to Chinese stocks by launching the Shanghai–Hong Kong stock connect program, in 2014. This program grants all foreign investors, not just investors licensed under the QFII program, access to a range of A shares traded in Shanghai. The program was expanded two years later to allow foreign investors access to shares traded in Shenzhen, China's second-largest stock exchange.

Over time, the Chinese regulators also expanded foreign access to corporate and sovereign bonds. Initially, access through the QFII program was limited to bonds traded on the exchange market. But in July 2012, QFIIs were allowed to enter the much larger China Interbank Bond Market (CIBM).[12] In 2015, the CIBM was opened to central banks, international financial institutions, and sovereign wealth funds. The following year, the ability to directly enter the CIBM was extended to commercial banks, insurance and securities firms, and asset managers.[13]

In July 2017, China launched the Bond Connect Program, which allowed all foreign investors access to the CIBM bond market. In September 2020, the regulators allowed foreign investors to directly buy and sell bonds traded on domestic exchanges.

An increasing number of domestic corporates are responding by announcing their intention to seek ratings from international credit rating agencies, paving the way for increased foreign ownership of corporate bonds.

Inclusion of Chinese Securities in Global Indices

In June 2017, MSCI announced the addition of Chinese A shares in its widely followed indices, including the MSCI Emerging Market Index and the MSCI All Country World (ACWI) Ex-US Index. The weights assigned to China in the two indices were 40.7 percent and 12.2 percent, respectively, by the end of November

12 About 80 percent of bonds are traded on the CIBM; the balance are traded on exchange markets.

13 For a detailed account of the opening up of China's onshore bond market, see Kai (2019).

2020.[14] FTSE Russell added A shares to its global equity index in September 2018. In phases ending in June 2020, it gradually increased the weight of A shares in its index to 6 percent. S&P Dow Jones indices first added Chinese A shares to its emerging market index (S&P Emerging BMI) in September 2019; by September 2020, it increased the weight of A shares to 8 percent.[15]

Inclusion of Chinese bonds in various global bond indices followed, with a slight lag. In April 2019, Chinese government and policy bank bonds were added to the Bloomberg-Barclays Global Aggregate Bond Index (BBGA). In February 2020, Chinese Treasury bonds were added to the JP Morgan Government Bond Index–Emerging Markets Global Diversified (JPM GBI-EMGD). In September 2020, FTSE Russell announced that it would add Chinese government bonds to its World Government Bond Index (WGBI) in March 2021. Each of these actions drives additional foreign investment into the Chinese onshore bond market. The action by FTSE Russell, for example, is estimated to lead to additional inflows of $140 billion into China's domestic bond market. None of these bond indices includes any Chinese corporate bonds.

Foreign investment in Chinese securities will continue to grow as financial firms gradually increase the weight of Chinese securities in their indices. For example, the inclusion of Chinese government and policy bank bonds in the Bloomberg-Barclays index began in April 2019, but the weight assigned to Chinese bonds is scheduled to increase over a 20-month period.

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Liberalization that Provides Foreign Investors with Mechanisms for Managing Risk

In June 2018, QFIIs were allowed to enter the foreign exchange derivatives market to hedge their foreign exchange risk. The Chinese Securities Regulatory Commission announced in September 2020 that all foreign investors would gain access to the domestic stock futures market, allowing them to hedge their stock positions. This reform took effect November 1, 2020.

Interest Rate Differentials on Bonds That Increasingly Favor China

After the US Federal Reserve cut rates sharply in response to the Covid-19 pandemic, the positive yield differential on 10-year government bonds in China compared with the United States widened to an average of more than 2 percentage points in the second half of 2020 (figure 3).[16] This yield differential in favor of Chinese bonds is likely to persist, because the Fed has signaled that it will keep US interest rates low for a considerable period and there is little likelihood of a rate cut in China to stimulate economic growth, given China's strong economic recovery starting in the second quarter of 2020.

14 See the factsheets of the MSCI Emerging Markets Index and the MSCI ACWI Ex-US Index. Chinese companies listed offshore were included in both indexes before the inclusion of A shares.

15 In addition, Chinese companies listed offshore accounted for 36 percent of the S&P Emerging Market Index as of September 21, 2020.

16 Because of the relatively high cost of hedging currency risk, hedged China–US yield differentials are lower than unhedged ones. See Cerutti and Obstfeld (2019).

Figure 3
Yields on US and Chinese Treasury bonds, January 2019–November 2020

Source: Federal Reserve Economic Data and China Securities Index via Wind.

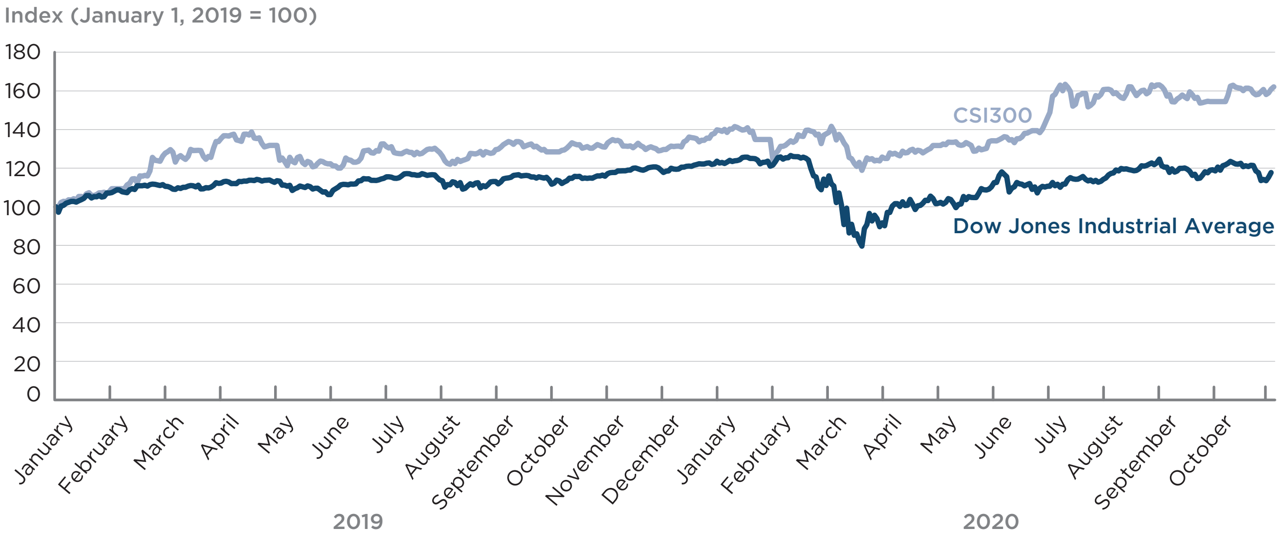
Figure 4
Renminbi–dollar exchange rate, January–December, 2020

Source: People's Bank of China via Wind.

Appreciation of the Renminbi

The renminbi appreciated about 6 percent vis-à-vis the dollar between January and early December 2020; from its low point in late May, it appreciated 8 percent (figure 4). Foreign investors can now both earn higher returns on Chinese bonds and convert their RMB earnings back into dollars at a more favorable rate.

Figure 5
Performance of China's CSI300 and the Dow Jones Industrial Average, January–October 2020



Source: Wind.

China's Reemergence as the World's Fastest-Growing Economy

China recovered rapidly from the Covid-19 pandemic. The International Monetary Fund forecasts that China will be the only major economy to experience economic growth in 2020. It forecasts that China's economy will expand by 10 percent over the course of 2020 and 2021 while virtually every other large economy will remain smaller in 2021 than in 2019. This growth performance reflects a recovery in profitability in Chinese industry, which appears to be contributing to China's stronger equity market performance compared with the United States (figure 5).

US EFFORTS TO LIMIT FINANCIAL INTEGRATION

Foreign financial investment in China is market driven. In contrast, in the United States, the government launched three programs to limit or reduce the trend of deepening financial integration. The first initiative was to delist Chinese companies traded on the New York Stock Exchange and NASDAQ if they do not comply with certain US auditing standards by 2022. The second was to overturn a decision of the US Federal Retirement Thrift Investment Board to modify the federal Thrift Savings Plan to provide US government employees access to a fund that includes a small slice of Chinese companies. As argued in an earlier blog (Lardy and Huang 2020), these initiatives are largely symbolic; neither is likely to affect the trend of further financial integration documented above.

A third, more recent initiative, announced by executive order on November 12, 2020 and effective January 11, 2021, precludes any new US investment in 31 Chinese firms alleged by the US Department of Defense to be linked to China's military.[17] The Department of Defense added four Chinese companies to its list on

17 White House Office of the Press Secretary, "Executive Order Addressing the Threat from Securities Investments that Finance Communist Chinee Military Companies," November 12, 2020.

December 3, 2020. Existing investment positions in these companies will have to be sold before November 11, 2021.[18]

Evaluating this new executive order is difficult, for two main reasons. First, 10 of the expanded list of 35 companies, including Huawei, are not publicly traded or have publicly traded subsidiaries in which the holdings of US investors are less than $30 million.[19] The impact of the ban on US direct investment in these companies will be small. Of the remaining 25 companies, only a few (such as the Semiconductor Manufacturing International Corporation [SMIC]), are publicly traded. All of the others have listed subsidiaries, some of which are large, but it is not clear whether the order covers these subsidiaries. Before January 11, 2021, the Treasury will presumably issue detailed guidelines, as it did when the US banned US investments in Russian and Venezuelan assets.

Second, assuming the US Treasury bans US investment in all listed subsidiaries of the 35 Chinese companies on the Department of Defense list, index providers will almost certainly drop the listed companies from their indices.[20] The action would eliminate not only US investment but also foreign investment through passive funds tied to the relevant indices. The move would certainly be disruptive in the short run, but it may not substantially alter the flow of US investment into Chinese equities. The Chinese companies that account for the largest weight in the MSCI China All Shares Index, the MSCI ACWI Ex-US Index, and the MSCI Emerging Market Index, for example, are Alibaba Group and Tencent Holdings. None of the traded subsidiaries of the companies on the Department of Defense list is among the top 10 constituents by market capitalization of these three indices.

LIKELY RECORD LEVEL OF INBOUND FOREIGN DIRECT INVESTMENT

Yet another domain in which decoupling is not happening is FDI in China. As a result of the Covid-19 pandemic, global FDI flows in the first half of 2020 declined by the largest amount on record. Inflows into the United States, usually the largest recipient of FDI, were down 61 percent; inflows into the European Union were off 29 percent. In contrast, inflows into China were down only 4 percent,[21] and China's monthly inflows have strengthened since. In the third quarter of 2020, FDI inflows expanded nearly 17 percent compared with the same period in 2019. As a result, cumulative FDI inflows through the third quarter of 2020 were up about 2 percent, putting China on track to set an annual record inflow of more than $140 billion.[22]

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18 US Department of Defense, "DOD Releases List of Additional Companies, In Accordance With Section 1237 of FY19 NDAA," December 3, 2020.

19 Calculated by the authors based on UBS, "China Equity Strategy: More on the DoD List and US-Listed China ADRs," November 30, 2020.

20 FT Russell will drop eight Chinese companies from its FTSE Global Equities Index and its FTSE China A Inclusion index effective December 21, 2020. It also announced that it will drop additional Chinese companies from its indices if the Treasury Department publishes a longer official list of banned companies. S&P Dow Jones will also drop certain Chinese securities from its equity and bond indices. See David Carnevali, Eric Platt, and Demetri Sevastopulo, "FTSE Russell Drops Eight Chinese Companies from Indices after Trump Order," Financial Times, December 4, 2020, and S&P Dow Jones Indices, "S&P Dow Jones Indices' Consultation on the Executive Order Prohibiting U.S. Transactions in Certain Chinese Companies Results," December 9, 2020.

21 Paul Hannon, "Foreign Investment Plummets During Pandemic, except in China," *Wall Street Journal*, October 27, 2020.

22 These data, compiled by China's Ministry of Commerce, are exclusive of investment in China's financial sector and probably exclusive of reinvestment of profits of nonfinancial foreign affiliates. Investment in China's financial sector reached almost $20 billion and reinvestment of profits of nonfinancial foreign affiliates more than $20 billion in 2019.

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