The Opening Up of China´s Capital Market: Between Liberalization and Stability

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In recent years, China made some progress in liberalizing its capital markets including opening up its capital account for foreign investors. A very recent step taken is the approval of foreign rating agencies to rate Chinese companies in China; a privilege that was before only given to Chinese rating agencies. In turn, this move could trigger more foreign investment in one of the largest bond markets in the world, with a volume of approximately USD 12 trillion. Already for some years, foreign institutional investors are allowed to invest certain amounts into the Chinese stock and bond markets through the so-called Hong Kong/China 'bond and stock connect'. With RMB 2 trillion EUR 300 billion, the amount is still small. However, foreign investors are hoping to get a stronger share soon; London and Frankfurt/China 'bond and stock connects' are currently under discussion. Other examples of liberalizations in recent years are China's inclusion in the MSCI and FTSE Stock index, the participation of the RMB in the special drawing rights of the IMF, as well as the announced easing of restrictions for foreign financial institutes for investments in Chinese financial institutions.

On the other hand, the liberalization and opening up of China's capital markets is still pretty slow despite of all progress in the past. There are more and more doubts that China will fully open its cross-border capital account and domestic capital market soon. The promise to develop Shanghai into an international finance center by 2020, for instance, is far from being realized. Also, the announcement around ten years ago allowing foreign companies to become listed at China's stock exchanges in Shanghai or Shenzhen, and then take the money out of China has not been fulfilled yet. And last but not least, the controls on the capital account are still in place.

Foreign exchange reserves in China

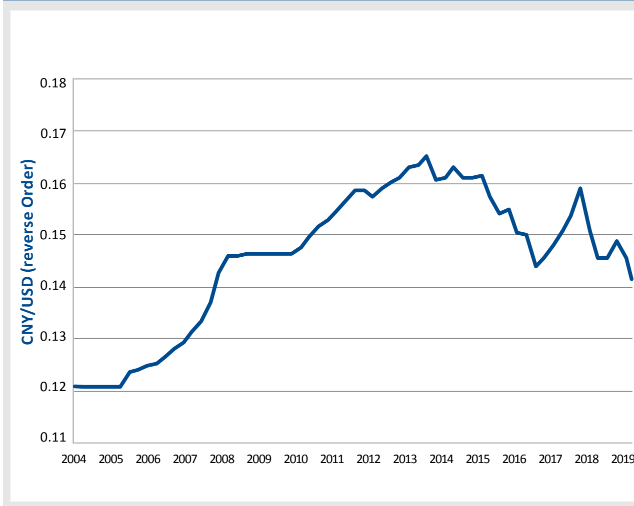
One of the main reasons for the slow opening up are stability and systemic risks concerns. The main topic in this regard is the stock of foreign exchange reserves of China. Currently, it is still above USD 3 trillion. However, it is still around USD 1.2 trillion below its peak before the crash of the stock market and strong capital outflows from mostly Chinese counterparties. This instance followed at the end of 2015 and continued into Q1 2016. It eventually also triggered a devaluation of the RMB against the currency basket including the US Dollar. It was a vicious cycle; the more pressure on the asset prices, especially the equity markets, the more it triggered capital outflows and RMB devaluation that in turn accelerate the capital outflows. Obviously, the effect on foreign reserves was enormous.

The government realized it must act against the drain of capital because it needs its foreign reserves to protect the RMB exchange rate, especially during tough depreciation tendencies. As a result, broader capital controls were introduced. At the

beginning, the authorities thought 'foreigners' triggered the outflow pressure, but they realized during the analysis Chinese corporates and individuals were the most active. Generally, the smaller the stock of foreign exchange reserves the more difficult it is for the Peoples Bank of China to protect the exchange rate. This is because the central bank needs foreign currency to buy their own in the foreign exchange market to stabilize the exchange rate in the face of downward pressure. However, a country with a currency in decline is not an attractive target for foreign financial and real investments due to exchange rate risks. Such a development could trigger another cycle of depreciation, capital flight, inflation, unemployment, and at the end social unrest; scenarios that we already have seen, for example in Turkey, Argentina or Thailand in the past.

The recent depreciation of the RMB against the USD below the line of seven as a response to additional tariffs for Chinese exports to the US for the remaining USD 300 billion of goods on foreign investors and their purchases of bonds and stocks is still to be seen. MSCI and FTSE stock index inclusion, the promise to increase the Qualified Foreign Institutional Investor quotas and the rise of the RMB as a reserve currency itself can help, but capital outflows pressure might intensify again.

Exchange Rate Development of the Renminbi



China's Current and Capital Account and Change of Foreign Exchange Reserves, 1998-2018

The main reason for the declining exchange reserve, currently at USD 3 trillion, is the downward trend of both the current and capital account. Due to the intensifying trade tension with the USA, it is expected that China's current account will become negative in 2019 after a tendency of decline that already started after the global financial crisis around ten years ago. A negative current account means that the value of the imports exceeds the value of the exports. Consequently, foreign exchange reserves will decline as well. Chinese importers will have to pay more foreign currencies than Chinese exporters receive.

The capital account of China, e.g. the cross-border inflows of capital and financial assets like credit, capital markets and foreign direct investment minus the respective outflows, has been negative for three consecutive years, and there is no such reason to believe that this will change soon. In principle this means financial and real investments in the world have become more attractive for Chinese companies and individuals than the other way around. Also, this development puts pressure on China's foreign currency reserves because more capital outflows than inflows results in a further decline of the reserve assets.

Foreign exchange reserves in China

In principle, there is a big variety of cross-border flows, both under current and capital account items. Foreign invested enterprises pay for their imports and services, dividend payments, repayment of shareholder loans, as well as cross-border cash pools and liquidity management solutions, a practice more common in the past. Total foreign direct investment is around USD 2.5-3 trillion, 20-30% of these assets are liquid.

However, Chinese state-owned and private companies as well as Chinese individuals account for a large part of cross-border flows as well. Dividend payments to offshore listed Chinese corporate account for around USD 50-100 billion; each Chinese individual is allowed to convert USD 50,000 equivalent of RMB into USD and remit it offshore. Hence, only ten million citizens can create USD 500 billion of outflows. Also, travel activities by Chinese citizens matter, with around USD 300 billion being spent offshore each year with an increasing trend. Moreover, there is at least USD 20 trillion of assets under management in the onshore private wealth sector. If only 5-10% of these assets are looking for a portfolio diversification into offshore (which is currently not allowed), this would create another USD 1-2 trillion of capital outflows. If we assume against this background that China would fully give up its capital controls, a potentially massive outflow of capital and hence a dramatic decline in foreign exchange reserves is a likely scenario. As a side effect, Chinese banks will lose cheap deposits which are needed to fund state-owned and privately-owned enterprises.

What's to come

However, systemic financial risks and potential instabilities do not necessarily mean that there will be no further progress of liberalization and opening up in the future. We are observing an opening up in the Insurance, Asset Management and Security Sectors. China needs foreign know how to ensure more efficient capital allocation to counter a declining growth rate of the overall economy. Actually, the growth rate of 6.2% in the second quarter of 2019 was the lowest since the years 1992. Until now, State Owned Enterprises absorb most of the credit allocation of Chinese banks, whereas China's private corporate sector including the small and medium size companies have still difficulties to obtain appropriate funding.

It is notable in this contact that for instance, just a few weeks ago one of the most important regulatory body, the National Development and Reform Commission launched a proposal that supports the business of private companies in China through better protection of intellectual property rights and lower market entry barriers. It is clear that a further liberalization and opening up of China's capital markets for foreign investors would also provide significant contribution for a better capital allocation that in turn benefit again China with higher growth rates as capital becomes more intelligent. Therefore, declining growth rates could become an important incentive to further open up China's capital markets. The capital account opening will most likely only further open in the direction of investments to China. Multinational companies need to closely watch the balance of payments as an indication of a possible policy shift to the reintroduction of cross border payment restrictions or capital controls.

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