

Liberalisation of China's Portfolio Flows and the Renminbi

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Abstract

China's equity and bond markets have grown rapidly to be among the largest in the world, yet, until recently, participation by foreign investors has been limited. Over recent decades, the Chinese authorities have relaxed investment restrictions to allow greater foreign access to these capital markets. This has enabled greater foreign investment and for global equity and bond index providers to increase the weight of Chinese securities in their indices, which are tracked by a range of global investment funds. These developments have contributed to an increase in gross foreign capital flows into China and they are likely to continue to support inflows in the period ahead. At the same time, an increase in Chinese resident portfolio outflows is also likely as domestic investors seek to diversify by investing abroad. The opening of China's financial markets entails benefits associated with deeper global financial integration, but may also contribute to greater variability in the renminbi.

Introduction

Over the past two decades, capital has flowed more freely across China's borders (Graph 1). The Chinese authorities have promoted increased cross-border capital flows as greater access to global financial markets offers potential benefits. For instance, increased gross foreign capital inflows can improve

the efficiency of investment and also enhance liquidity in China's financial markets (thus lowering financing costs for Chinese borrowers). Increased outbound investment in foreign assets can enable Chinese residents to access a wider range of investment opportunities and to diversify risk.

The process of opening China's capital account has been deliberately gradual and controlled (McCowage 2018). This reflects the lessons learned from other developing countries that quickly opened their capital accounts to foreign investors. For instance, in the lead-up to the east Asian financial crisis, many emerging market economies relied on short-term US dollar-denominated funding from foreign investors, had large current account deficits, fixed exchange rates and low foreign currency reserves. These factors, together with insufficient corporate governance and regulatory frameworks which enabled excessive risk-taking, contributed to a severe financial crisis in several east Asian economies when foreign banks and investors rapidly withdrew financing (IMF 2012).

In the early stages of opening China's capital account, Chinese authorities prioritised foreign capital inflows that were channelled toward direct ownership stakes in firms or projects, known as foreign direct investment (FDI) (Graph 2). This was intended to minimise the risk of a sudden reversal of capital flows and a large movement in the exchange rate, as FDI tends to be a longer-term investment and therefore more stable than investment in financial market securities such as equities and bonds. Foreign purchases of securities tend to be more susceptible to rapid reversals in a time of stress as foreign investors can more readily sell and repatriate their investments back to their home country (IMF 2016).

As part of the internationalisation of the Chinese renminbi (RMB), the authorities have eased

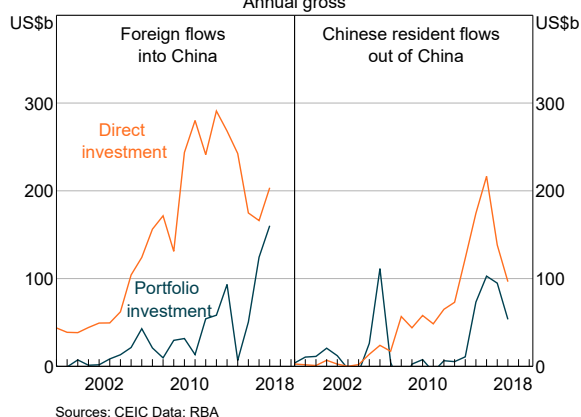
restrictions on banking-related flows since 2007 (Hatzvi, Meredith and Nixon 2015, and McCowage 2018).^[1] These flows have proved to be volatile. From late 2014, market conditions changed markedly and expectations of an easing of monetary policy and depreciation of the Chinese renminbi (RMB) triggered flows (mostly channelled through the domestic banking system) out of China. To mitigate the large outflows conducted via domestic banks, the authorities implemented new capital controls and enforced existing controls more stringently, while also attempting to smooth volatility in the exchange rate. At the same time, the authorities continued to encourage foreign capital inflows.

Since then, the authorities' focus has turned to progressing the liberalisation of the capital account by easing restrictions on foreign investment in China's onshore equity and debt securities markets, known as portfolio flows. This has led to a number of global equity and bond index providers recently announcing an increase in the weight of Chinese securities in their indices, which are tracked by a range of global investment funds. Running parallel with these developments have been efforts by the authorities to allow variability in the RMB to reflect fundamental market and economic forces.

The remainder of this article focuses on the liberalisation of portfolio flows and has two parts: first, it describes the progress of China's capital account liberalisation over time, particularly foreign access to China's onshore equity and bond markets.

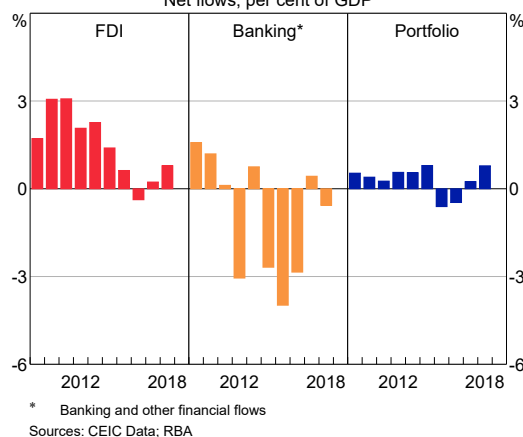
Graph 1

China – Investment Flows
Annual gross



Graph 2

China – Capital Flows
Net flows, per cent of GDP



Second, it discusses how the authorities have managed the liberalisation of these capital flows in conjunction with efforts to promote a greater role for market-based pricing in setting the value of the RMB.

Foreign Participation in China's Capital Markets

China's capital markets have grown rapidly over the past decade. Currently, China's onshore equity and debt securities markets are the second and third largest in the world by value, each accounting for about 10 per cent of the global market (Graph 3).^[2] China's onshore capital markets have attracted attention from global investors seeking to gain more exposure to China's growing economy – the aggregate exposure of international investors to China's capital markets is far smaller than China's weight in the global economy. Currently, only around 4 per cent of onshore equities and 2 per cent of onshore debt securities are owned by foreign investors. This is low by international standards (Graph 4). Investing in Chinese securities has also allowed investors to diversify their risk as Chinese securities appear to have low (albeit increasing) correlation with other global financial market assets. In addition, Chinese Government bonds offer higher real yields than those of developed and some developing countries.

The market for Chinese Government Securities is where foreign participation has increased most notably in recent years, with the foreign ownership

share currently around 8 per cent (Graph 5). The bulk of foreign holdings of Chinese Central Government bonds are held by foreign official institutions – and around one-third of foreign holdings is estimated to be held by the Central Bank of Russia (CBR) alone.^[3]

Gradual Liberalisation of China's Portfolio Flows

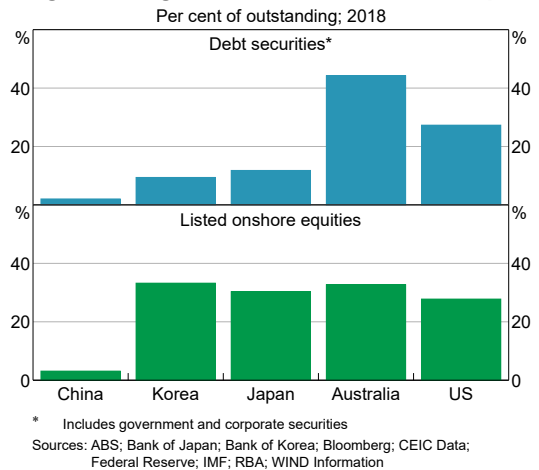
Chinese authorities have introduced a sequence of investment schemes to facilitate foreign access to China's onshore equity and bond markets (Table 1). These schemes were designed to balance the benefits of greater foreign participation against the risks of increasing portfolio flows too rapidly. Over time, authorities have gradually relaxed the restrictive nature of these schemes, eventually leading to Chinese onshore assets being included in

Graph 3



Graph 4

Foreign Holdings of Debt Securities and Equities



Graph 5

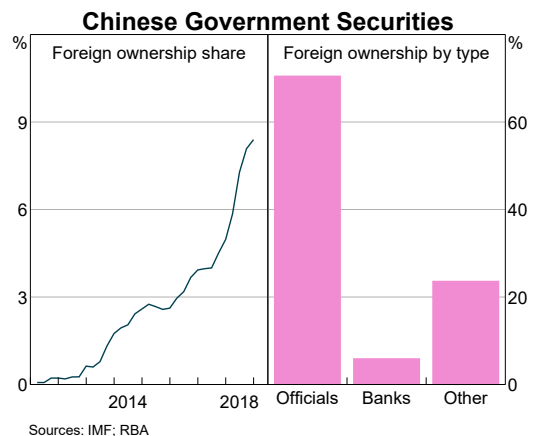


Table 1: Investment Schemes for Foreign Investor to Access China's Capital Markets

	QFII/RQFII	CIBM Direct	Stock Connect	Bond Connect
Date introduced	2002/2011	2015	2014	2017
Eligible securities	Onshore equities and bonds	Bonds	Onshore equities	Bonds
Investor types^(a)	Institutional	Institutional	Institutional and individuals	Institutional
Aggregate quota	Yes	No	No ^(c)	No
Approval process	Difficult	Difficult	Simple	Simple
Clearing and settlement	Onshore	Onshore	Offshore	Offshore
Foreign exchange hedging	Yes ^(b)	Yes	Yes	Yes

(a) Subject to eligibility criteria

(b) RQFII does not allow for onshore hedging

(c) There is a daily net purchase quota in northbound flows

Sources: PBC; Stock Connect; Bond Connect; IMF; RBA

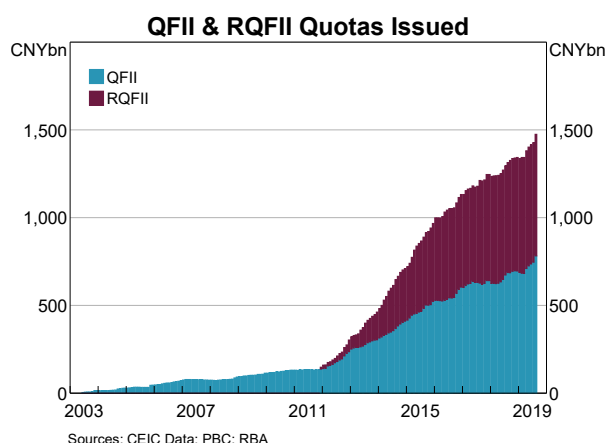
global benchmark indices. Achieving index inclusion is part of a broader agenda for China to open up its capital markets and internationalise the RMB.

A first step in the opening of China's capital markets was the introduction of the Qualified Foreign Institutional Investor (QFII) scheme in 2002, which allowed foreign investment up to a given quota (Graph 6). This scheme was further expanded in 2011 by introducing the Renminbi QFII (RQFII) scheme, which allowed institutional investors to use offshore RMB – RMB held in accounts outside of mainland China – to access China's capital markets.^[4] Promoting the use of the offshore RMB market through RQFII was a means of further developing and increasing the depth of the offshore RMB market.

These schemes provided highly regulated access to financial markets in China as they involved comprehensive investment and approval processes, lock-up periods to repatriate investment principal, and limited quotas (currently the aggregate quota is only around 1 per cent of the size of China's onshore equity and debt markets). To complement the QFII schemes, foreign central banks, sovereign wealth funds and select institutional investors were granted priority access by the authorities to China's interbank bond market (CIBM Direct). However, foreign participation remained low because the

scheme was generally considered too tightly controlled.

Over time, Chinese authorities have relaxed restrictions and introduced new schemes – particularly Stock Connect and Bond Connect – to encourage greater portfolio investment (Table 1). The 'Connect' programs are two-way programs that link financial infrastructures between mainland China and Hong Kong, allowing trades to be settled using international trading platforms and offshore settlement agents in Hong Kong. In addition, there are no aggregate quotas imposed and the approval process is relatively streamlined. The attractiveness of the Connect programs is reflected by the increase in the share of foreign holdings held

Graph 6

through these schemes, and has been one of the main reasons that led to benchmark index inclusion (Graph 7).

Index Inclusion Following the Creation of Stock and Bond Connect

In the past, index providers had been reluctant to allocate a large weight to Chinese securities in their benchmark indices because of concerns that capital flow restrictions would make it difficult for investors to replicate or closely track the index. The relaxation of foreign investment rules in recent years; the expansion of some onshore hedging instruments available to foreign investors; and the creation of the Bond Connect and Stock Connect schemes have collectively reduced some of these concerns. Ongoing capital account liberalisation would be supportive of a further increase in gross portfolio flows to China.

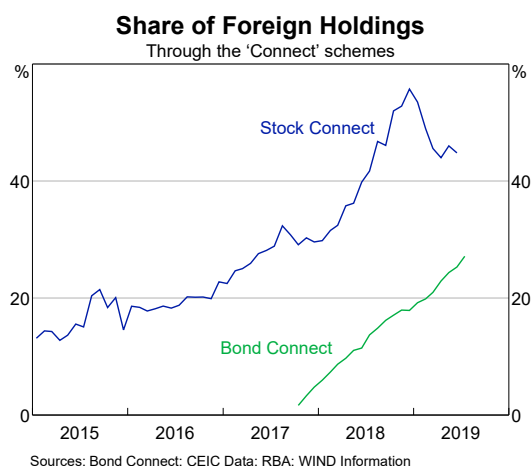
In early 2018, in anticipation of increased portfolio inflows and expectations that index providers would increase their weight of Chinese securities in their benchmark indices, the authorities substantially increased the daily Stock Connect quota of foreign investment into China (often called 'northbound' investment). The quota was increased to a daily net purchase of around CNY100 billion, or around 0.2 per cent of the market capitalisation of Chinese onshore equities (Graph 8). Given that index providers have only gradually phased Chinese securities into their indices, which has given investors time to adjust their portfolio allocations,

the daily quota has not been a constraint to further inward portfolio investment.

That said, there are a number of reasons why the weight of Chinese assets in global benchmark indices is likely to increase only gradually over time, and therefore remain below China's weight in the global economy. In fixed income markets, Chinese corporate bonds and local government bonds are still relatively illiquid and the credit rating system used for Chinese domestic securities is not consistent with international ratings.^[5] Similarly, future increases in the weighting of Chinese onshore equities in global benchmarks is likely to be gradual, reflecting ongoing impediments to foreign investors' ability to freely trade in these securities. These include the limited active shares, as around 60 per cent of the onshore market is estimated to be not tradeable (Gatley, 2019), and Chinese authorities imposing a 30 per cent limit on foreign ownership of individual stocks.

Simple calculations suggest that index inclusion could generate large portfolio inflows. For example, it is estimated to generate a cumulative gross portfolio inflow of almost USD400bn over the next few years, or around 3 per cent of Chinese GDP (Figure 1).^[6] For bonds, if realised, this additional flow should bring the share of foreign holdings of general government debt securities to around 25 per cent, above those of developed Asian countries such as Japan and Korea (at around 15 per cent). For equities, if realised, the additional flow represents only around 1 per cent of the

Graph 7



Graph 8

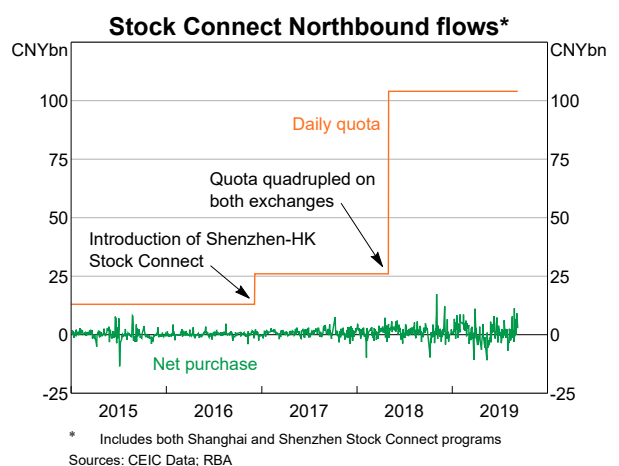
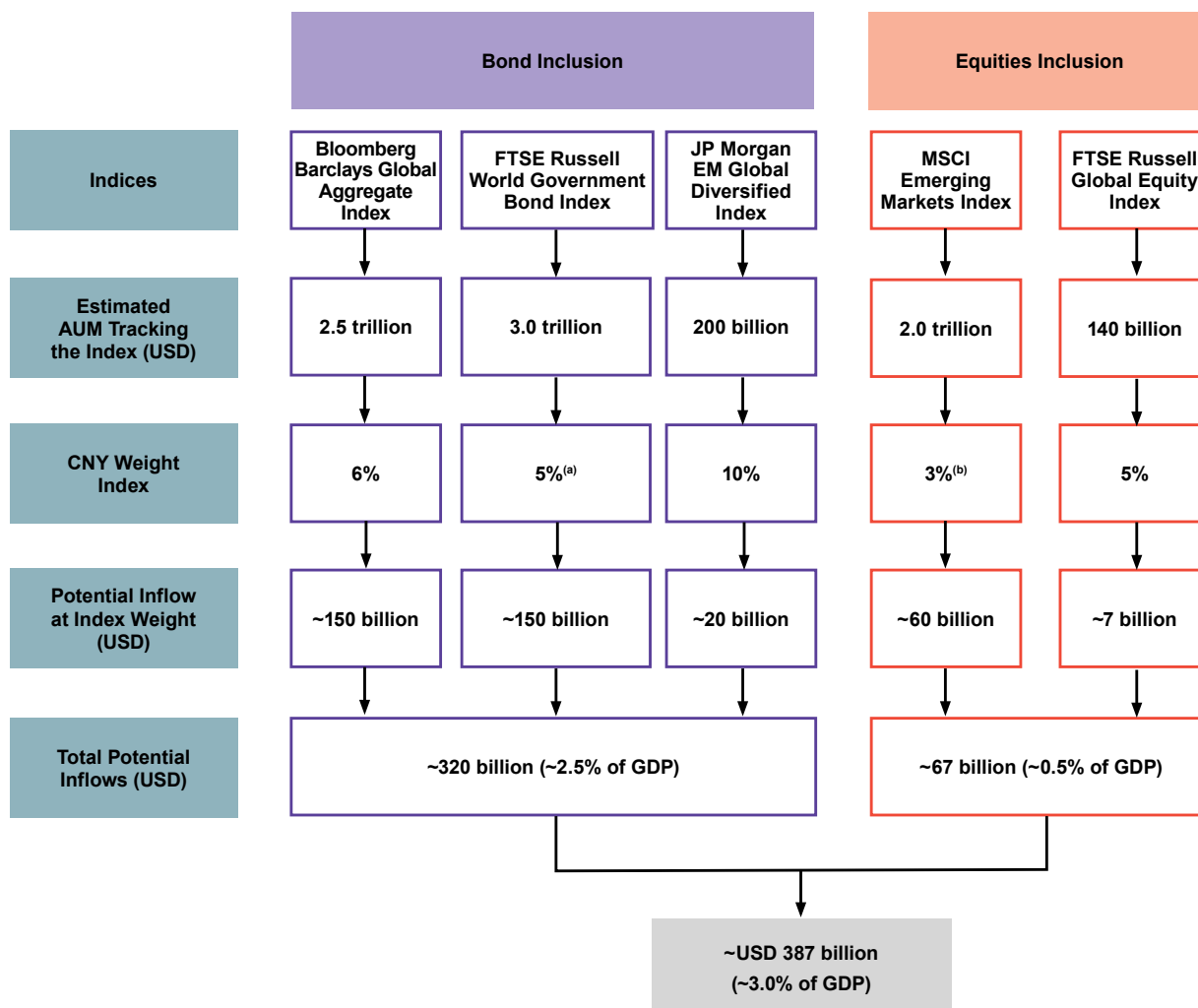


Figure 1
Potential Chinese Onshore Portfolio Inflows from Index Inclusion
(Indicative figures)



(a) Estimation as FTSE Russell has yet to announce the expected weight.

(b) Reflects the increase in weighting announced in 2019.

Sources: Bloomberg; FTSE; JP Morgan; Nomura; Queensland Investment Corporation; RBA; Reuters

onshore equity market capitalisation, which would bring the foreign investor share to around 5 per cent, well below the foreign holdings of equities in other developed countries (Graph 5). That said, these estimates are very uncertain.

Implications for the RMB

Further opening of China's financial markets to international investors (including through, but not limited to, global benchmarks) has potentially significant implications for the RMB. Increased gross portfolio investment into China will increase the

demand for RMB, putting upward pressure on the exchange rate, while increased gross portfolio investment abroad by Chinese residents will work in the other direction. The net directional effect on the value of the exchange rate at any point will depend on which of these gross flows are larger, but both will unambiguously increase traded volumes (and thus liquidity) in the RMB.

Alongside increased trading volumes in the RMB, a greater tolerance for exchange rate flexibility is likely to be necessary as the capital account becomes more open. If the exchange rate is not permitted to

adjust to market forces, the authorities may need to intervene in foreign exchange markets to counter depreciation (or appreciation) pressures associated with capital flows. If intent on leaning against market forces (such as portfolio flows) affecting the exchange rate via monetary policy, the authorities may also have to relinquish their ability to set domestic monetary conditions to best suit prevailing domestic economic conditions (Obstfeld and Taylor, 1997).

The Chinese authorities have allowed the RMB to become more flexible over time alongside efforts to partially liberalise China's capital account. Each morning, the authorities set the daily fixing rate based on the previous business day's spot close and overnight market movements, and permit the RMB to trade within a fixed band around the fixing rate (Halperin and Windsor 2018). The continuing use of the daily fixing rate has allowed the authorities to retain a degree of influence over the exchange rate. However, over time, the trading band has been widened from ± 0.3 to ± 2.0 per cent. This has allowed a modest increase in RMB volatility as the exchange rate has become more responsive to market developments (Graph 9). This increased flexibility has also seen the frequency and size of foreign currency intervention diminish over time. However, volatility of the RMB still remains low relative to free-floating currencies of advanced economies, and compared to the currencies of other emerging economies following liberalisation of their capital accounts.

Greater capital flows as a result of the ongoing liberalisation of China's capital account may result in a further increase in volatility in the exchange rate. Increased exchange rate volatility and volumes of gross portfolio flows (in and out of China) are likely to necessitate further development of Chinese derivative markets, in order to allow investors to better manage exchange rate risks. As large fluctuations in the exchange rate have been rare in China, this is likely to have contributed to the slow development of China's foreign exchange derivative markets (Garner 2017).

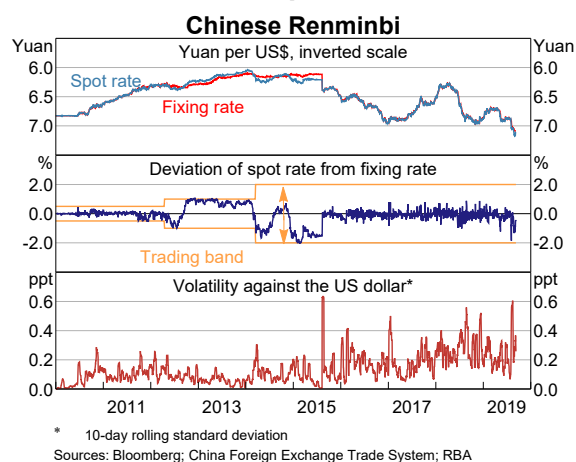
To the extent that gross portfolio outflows continue to increase and the RMB becomes more market determined, it will also lead to a shift in the nature of China's participation in global financial markets. More resident portfolio investment abroad, coupled with a reduced need for China's central bank to hold foreign exchange reserves, could see the role of the Chinese private sector become more consequential in global financial markets. This, in turn, may result in a shift in the global asset allocations of Chinese investors, as the private sector is likely to hold more diversified portfolios relative to the official sector, which has been primarily invested in the government bonds of advanced economies.

China's increased integration in the global financial system may also lead to Chinese financial conditions exerting a larger impact on global financial conditions, and vice versa.

Conclusion

China has recently taken steps to improve foreign access to its onshore equity and bond markets. This marks further progress in capital account liberalisation. Countries that have previously liberalised their capital accounts have generally mitigated the risks of doing so by developing hedging markets and other financial market infrastructure. Greater flexibility in the RMB also offers the potential benefit of increased monetary policy independence in China. ✎

Graph 9



Footnotes

- [*] The authors are from International Department and would like to thank Jarkko Jaaskela, Dana Lawson and David Lancaster for their comments and suggestions.
- [1] Banking-related flows mostly constitute loans, currency & deposits and trade credit & advances. Banking-related outflows increased significantly between 2014 and 2016. Official statistics also indicate large discrepancies during this period, suggesting outflows could be larger than those shown in Graph 3.
- [2] These figures excludes securities of Chinese companies that are listed offshore and denominated in either a foreign currency or offshore RMB (CNH). Offshore-listed equities account for around 35 per cent of the market capitalisation of all Chinese listed stocks. Debt securities issued offshore account for around 5 per cent of all Chinese bonds outstanding.
- [3] The large share of holdings from the CBR reflects a transition away from holding US dollars over the past few years following sanctions imposed by the United States on Russia.
- [4] To internationalise the RMB and promote its use in international trade, without having to fully open its capital account, China created an offshore RMB market in 2009.
- [5] Domestic credit agencies apply looser standards when rating onshore debt securities than those used in other international markets. This makes it more difficult for debt investors to assess the riskiness of Chinese bonds. For example, a BBB- or below credit rating by international credit ratings agencies is considered non-investment grade. In contrast, in China a AA- or below credit rating by domestic rating agencies is considered non-investment grade – that is, a company with a AA-credit rating in China is considered riskier than a company with a AA-rating in other markets.
- [6] The cumulative portfolio flow is calculated by taking the value of assets under management that track key benchmark indices that have (or will likely) include Chinese securities into their indices, then multiplying by the expected increase in the weight of Chinese securities in these indices.

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