

# China's Evolving Financial System and Its Global Importance

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## Abstract

China's economic policy response to the COVID-19 pandemic has been less stimulatory than the response after the global financial crisis because Chinese authorities have sought to avoid fuelling risks in the financial system. Indeed, the authorities have continued with reforms to make the financial system more market-based so that it can better support China's economy, although the state continues to play a central role in the financial system. At the same time, China has become increasingly important for international financial markets, mainly due to its weight in international trade but also because certain cross-border capital flows are rising.

## Introduction

In the years following the global financial crisis (GFC), Chinese policymakers supported a period of rapid economic growth despite the weak global environment. This stimulus resulted in strong credit growth and was accompanied by a rise in financial vulnerabilities.<sup>[1]</sup> The stock of debt rose substantially, concentrated in state-owned enterprises (SOEs) that were burdened by over-capacity (Graph 1). An opaque and largely unregulated 'shadow' financial system emerged. This was accompanied by a widespread belief that a range of financial assets would be guaranteed by

the state. In addition, an easing in the economy's trend rate of growth has meant that it has become harder to 'outgrow' any problems in the financial system (Roberts and Russell 2019).

Some years ago, the Chinese authorities began to focus more attention on reducing financial risks, along with a number of other long-term goals (such as environmental sustainability), accepting slower growth in the process. These efforts were successful in a number of ways. Economy-wide leverage stabilised, albeit at a high level relative to other economies at a similar stage of development. The stock of shadow financing declined from

60 per cent to 45 per cent of GDP as regulatory scrutiny was tightened and the bond and equity markets were developed as more transparent alternatives (Sutton and Taylor 2020). In addition, the authorities demonstrated a willingness to allow some investors to incur losses on a range of assets previously assumed to be guaranteed by the government.

The rise in vulnerabilities over the past decade or so has shaped the policy responses to the pandemic, as is discussed in the first part of this article. The article then turns to the long-running efforts to reconfigure the way that the Chinese financial system supports the economy, which has gained renewed focus since the onset of the pandemic. Finally, the article puts these developments into an international context, by examining how the global importance of the Chinese financial system is changing.

### How has the pandemic response been affected by risks in China's financial system?

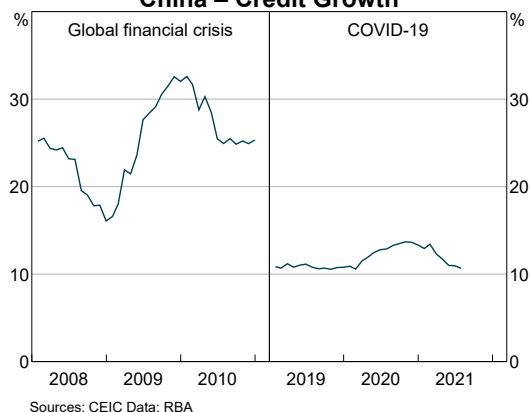
With work still to be done to address these financial system vulnerabilities at the outset of the COVID-19 pandemic, the authorities have been alert to avoiding a further rise in systemic risks where possible. In particular, the *scale* of monetary stimulus in response to the pandemic has been modest, particularly compared with the large-scale easing during the GFC. Credit growth rose but by far

less than in earlier episodes (Graph 2). Interest rates on bank loans declined by around 50 basis points compared with around 200 basis points during the GFC.

Monetary stimulus has also been quite *targeted*, favouring specific borrowers to avoid fuelling a further rise in systemic risks. There has been renewed emphasis on banks orienting credit towards small and medium-sized businesses rather than SOEs. These firms tend to have more sustainable debt loads and have faced more difficulties obtaining finance (particularly during the earlier campaign to reduce financial risks) (Graph 3). At the same time, various steps have been taken to avoid unnecessary stimulus of the property market, including limits on lending for mortgages and to higher-risk property developers.

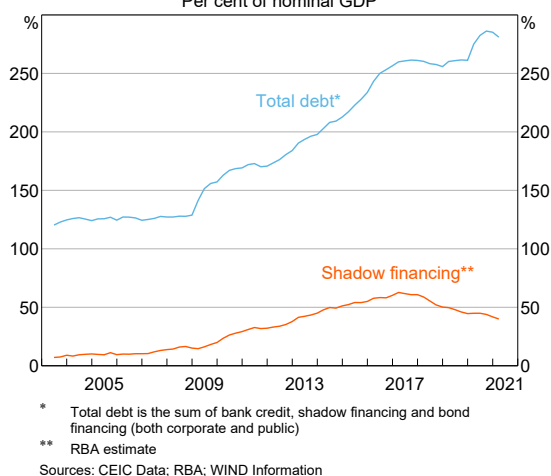
**Graph 2**

**China – Credit Growth**



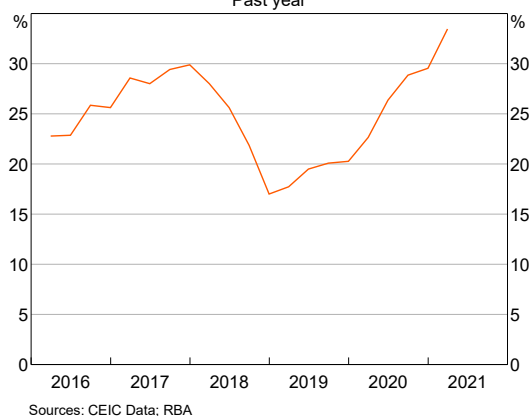
**Graph 1**

**China – Non-financial Sector Debt**  
Per cent of nominal GDP



**Graph 3**

**Medium and Small Enterprises' Share of New Business Financing**  
Past year



This approach has been aided by the successful containment of the virus and the strong recovery in demand for China's exports, which has seen the economy quickly return to its pre-pandemic trajectory.

The more modest expansion of credit in this episode also reflected a smaller degree of fiscal stimulus (Graph 4). Unlike most economies, a degree of fiscal stimulus in China is often funded by borrowing from the banking system or from shadow finance via local government financing vehicles (LGFVs). That is because fiscal stimulus is delivered largely by local governments and SOEs, in contrast to other economies where fiscal stimulus is reflected mainly in the central government budget balance. To reduce the use of shadow finance and impose a degree of market discipline, in recent years local governments have been encouraged to access the bond market by issuing 'special' bonds linked to specific projects (Holmes and Lancaster 2019).

Despite the modest and targeted policy responses to the pandemic, the authorities tolerated an increase in debt relative to GDP (Yi 2020). Further reforms to address the still-large stock of shadow financing were also delayed.

Accordingly, as economic activity continued to recover this year, the authorities proceeded with a tapering of stimulus. At the meeting of the National People's Congress early in 2021, authorities approved a plan to ensure that the growth of credit slows this year, such that it stabilises relative to

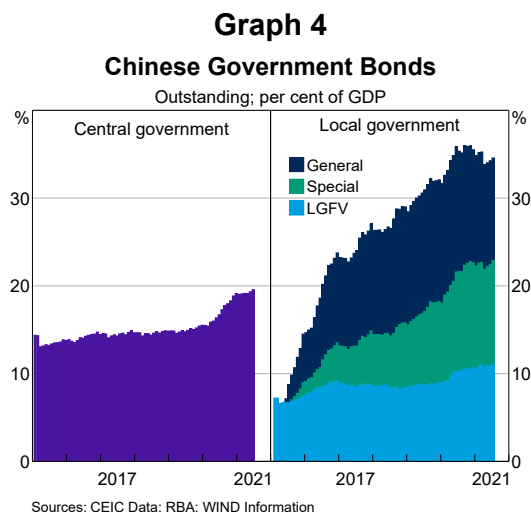
nominal GDP, and announced a modest tightening of fiscal policy (National Development and Reform Commission 2021). Authorities also chose a GDP growth target for 2021 that could be met provided the economy did not subsequently contract, limiting the potential for conflict between that target and measures to reduce financial risk. As intended, credit growth has slowed to a rate that has been in line with the growth of nominal GDP.

### How is China's financial system being reformed?

The pandemic has also underscored the authorities' long-running efforts to pursue deeper reforms that improve the stability and efficiency of the financial system so that it can better support economic growth. Historically, the state intervened heavily to ensure that the financial sector supported an investment- and export-led model of economic growth. This included:

1. a heavy bias in the allocation of credit to SOEs over private and/or small enterprises, especially by the dominant state-owned banking sector – even as banks became more commercial, implicit state guarantees meant that SOEs continued to enjoy preferential access to credit
2. controls on interest rates, which were set at artificially low and stable levels – low borrowing rates for SOEs assisted in channelling high rates of private savings into state-led investment at subsidised cost
3. a managed exchange rate and restrictions on capital flows, which prevented domestic savers from moving into higher-yielding assets abroad and insulated the economy from volatility in foreign capital flows (an exception was direct investment in China by foreign corporations, which was typically longer-term and involved the transfer of foreign technologies).

That model was acknowledged as having several drawbacks. First, it contributed to the build-up of financial vulnerabilities. Inefficient investment in the state sector was encouraged, and many investors and borrowers sought better deals in the shadow financial system. As investors progressively sought new ways to earn higher returns, excessive risk-



taking arose in different parts of the financial system. Second, the system lacked key macroeconomic shock absorbers, in the form of a more flexible exchange rate and countercyclical interest rate tools. Third, it tended to deprive fast-growing private-sector industries of finance.

As a result, the authorities have pursued several reforms over the past decade, including: reducing implicit guarantees of SOEs; increasingly using changes in interest rates to influence financial conditions; and gradually opening the capital account and allowing for a more flexible exchange rate. The past year or so has seen some important developments in these areas and posed questions about the future direction of the reform process.<sup>[2]</sup>

### Reducing implicit guarantees

In recent years, the authorities have allowed a series of defaults by entities that were previously assumed to have been guaranteed. That has included SOEs and some large private firms (mainly property developers) (Graph 5). Several small banks have experienced capital shortfalls, resulting in the first bank failures in China in 20 years (RBA 2019). While such defaults remain much less common than in other economies, they are a marked shift from China's past.

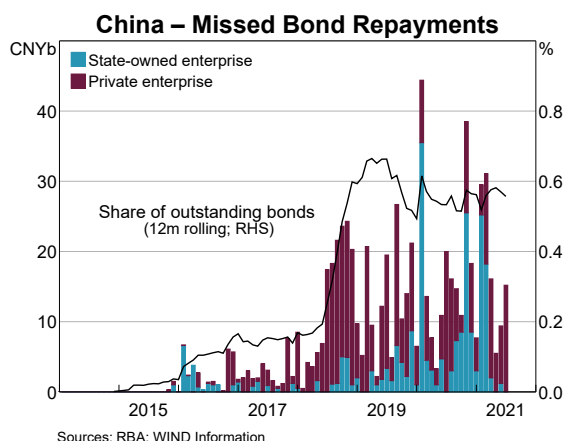
These events mean that investors now face more credit risk than before, and as a result some higher-risk borrowers now find it more expensive and more difficult to obtain credit.<sup>[3]</sup> In particular, financing conditions have diverged for borrowers in different provinces, because of the important role that has

been played by local government backing (Graph 6). Indeed, the central authorities have emphasised that local (rather than central) authorities are responsible for resolving the risks of certain borrowers, notably troubled banks in their provinces. However, the consequences of defaults for local governments can be significant, and some have temporarily extended additional support to local SOEs while they restructure their finances (He 2021).

As a result of the weakening of guarantees, and transfer of credit risk to investors, credit is now starting to be allocated more towards regions that can deploy it more efficiently and sustainably. Regions with industries burdened by over-capacity and shrinking populations tend to have local governments with higher debt burdens, which reduces their capacity to support local firms, both state-owned and private (Feng and Wright 2020; Wright and Feng 2021). That has been the case especially for the provinces in north-eastern China (notably Liaoning) that have been struggling economically. For such provinces, funding costs in the bond market for local SOEs have risen over the past year or so, and credit growth has been slower than in other provinces (Graph 7).

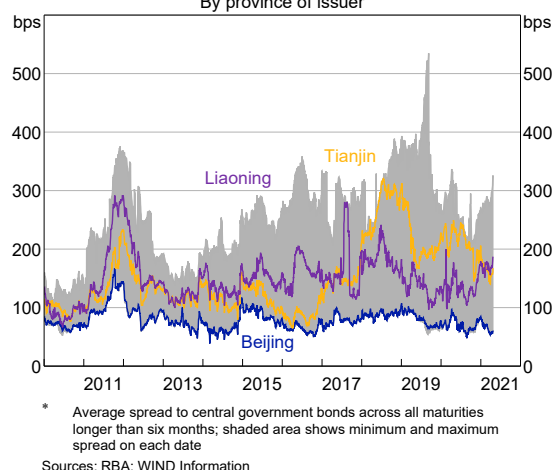
While some state-backed borrowers now face greater scrutiny, improvements in the availability of finance for small and private enterprises have lagged (Bowman 2019; Bunny 2020). The bond market remains heavily dominated by SOEs, while

**Graph 5**



**Graph 6**

**China – Corporate Bond Spreads\***  
By province of issuer



private firms still face elevated funding costs. To address this, a range of other policies have been used to encourage banks to provide more credit to small businesses and improve private firms' access to equity capital (IMF 2021b).

While helpful for ensuring investments are made efficiently, allowing investors to incur losses has posed a risk of triggering wider financial stress. Each credit event has prompted a reassessment of assets that were previously considered safe. For example, the first small bank failure in 2019 saw interbank funding markets freeze up. Also, the default of a major SOE in late 2020 saw a widening of spreads and corporations found that it was very difficult to raise funds in the bond market for a time. In each case, the People's Bank of China (PBC) has injected substantial liquidity into interbank markets, which has been effective in avoiding wider spillovers to other parts of the system.

Looking ahead, while GDP has recovered quickly and this has alleviated some risks, banks also remain exposed to a rise in non-performing loans. That is especially true of smaller banks, and PBC stress tests at the end of 2020 also indicated that some medium and large banks could fall short of minimum capital requirements even under 'mild' scenarios (PBC 2020) (Graph 8). In some cases, those exposures have risen because of loans extended to smaller firms (which lack a state backstop) or to SOEs whose government backing has weakened. Capital shortfalls among small banks are likely to be

resolved slowly with a mix of recapitalisation and acquisitions, but there may also be further bankruptcies (Wu, Zhu and Shen 2020).

**Interest rate reform**

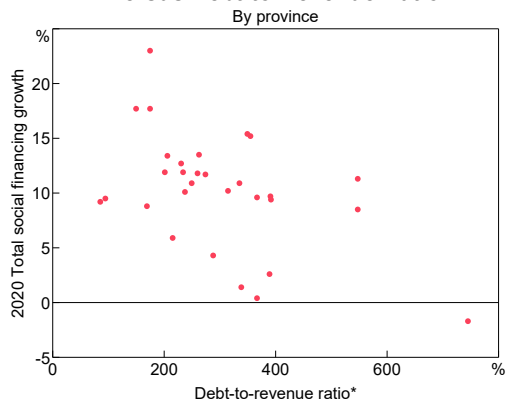
The authorities have gradually deregulated interest rates over the past couple of decades. Artificially low interest rates encouraged investors to seek higher returns, including in the (less regulated) shadow financial system and by speculating in property. Interest rate controls also made lending to the private sector unattractive because banks could not charge higher rates to compensate for the risks involved.<sup>[4]</sup>

Interest rate controls also meant that short-term interest rates in money markets had little bearing on the rates faced by end borrowers (though those rates were adjusted directly at times). So instead of adjusting short-term interest rates, monetary policy was adjusted by directly guiding banks to expand credit and facilitating this by lowering reserve requirements and extending central bank funding ('quantity-based' tools) (Jones and Bowman 2019).

As interest rates were liberalised, it became more effective to use short-term interest rates as a countercyclical ('price-based') tool. Several other steps were taken that have helped to bolster the effectiveness of this tool further. A deep interbank money market was developed and the PBC improved its control over interbank interest rates (Jones and Bowman 2019). A more liquid yield curve for government bonds was developed, which

**Graph 7**

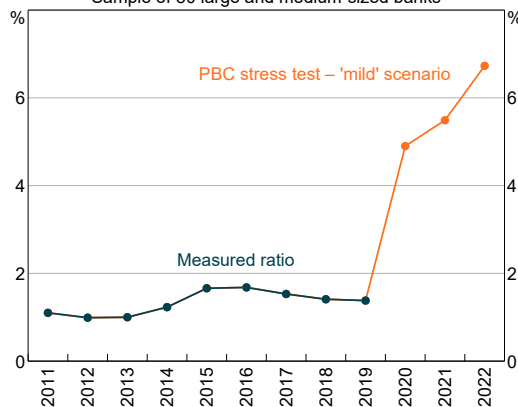
**Growth in Total Social Financing versus Debt-to-Revenue Ratio**



\* 2019 debt-to-revenue ratio only includes bond debt  
Sources: RBA; Rhodium Group; WIND Information

**Graph 8**

**China – Non-Performing Loans**  
Sample of 30 large and medium-sized banks



Sources: CEIC Data; People's Bank of China; RBA

embodies expected future short-term interest rates and provides a benchmark for other issuers in the bond market. Finally, interest rates on bank loans were linked to a new benchmark (the Loan Prime Rate, LPR), which tracks rates on the PBC's facilities for lending to banks (specifically, the Medium-term Lending Facility, MLF).

During the pandemic, these new price-based tools were employed as part of the PBC's modest and targeted easing. Money market interest rates were lowered, which transmitted to lower borrowing costs for governments and corporations in the bond market (Graph 9). A small decline in the MLF rate was passed through to the LPR and business lending rates.<sup>[5]</sup>

Nevertheless, monetary policy still relies on an array of quantitative tools and direct guidance, including as part of the pandemic response (IMF 2021b). Moreover, the incomplete nature of interest rate reform has constrained the use of price-based tools. For example, more of the easing passed through to bank lending rates than to deposit rates (which remain subject to more controls), thereby putting pressure on bank profits (Zhang 2021).

### Capital account reform

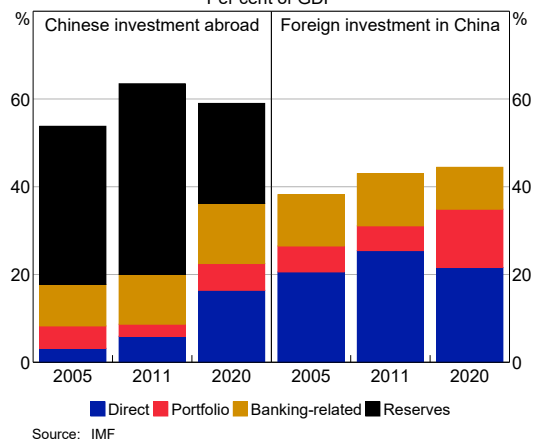
Following the GFC, the authorities opened up further to cross-border capital flows. The overall strategy was to liberalise inflows before outflows, given the potential for sizeable outflows of domestic savings into foreign assets. As well as permitting inflows of 'direct investment' by foreign

corporations, cross-border banking inflows were favoured because they were expected to support use of the renminbi internationally and expose the domestic banks to helpful competition (Graph 10). 'Portfolio flows' into bond and equity markets were not liberalised initially, because they tend to be relatively volatile.

With greater openness to capital flows, it was necessary for the renminbi to become more flexible and market-based (Lien and Sunner 2019). But in 2015, a slowing of the economy and an easing in monetary policy prompted more capital outflows and pressure for depreciation, and the authorities intervened to support the currency and halted the process of opening up (McCowage 2018) (Graph 11).

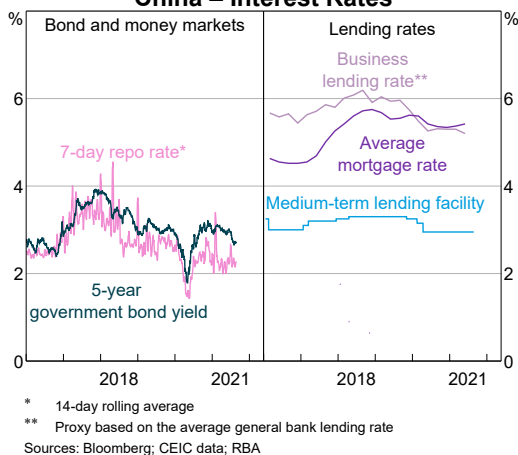
**Graph 10**

**China – External Position**  
Per cent of GDP



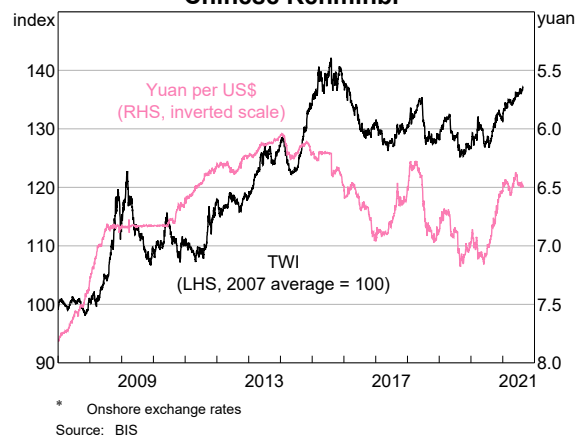
**Graph 9**

**China – Interest Rates**



**Graph 11**

**Chinese Renminbi\***



Since then, there have been several steps towards liberalising capital flows. Most importantly, foreign portfolio investors have been given much greater access to Chinese bond and equity markets. That is seen as helpful for developing these markets, as well as supporting the use of the renminbi in international finance and trade. Specific steps include: the opening of 'connect' schemes between exchanges in China, Hong Kong and London (with more under development); the inclusion of Chinese onshore bonds and equities in international indices that form a benchmark for around US\$8 trillion of investments; and giving foreign investors more access to derivatives markets to manage the risks of their investments.<sup>[6]</sup>

As a result, portfolio inflows have, for the first time, been among the largest sources of foreign capital inflows to China, even exceeding direct investment in recent quarters (Graph 12). Moreover, recent inflows have been mainly from private investors, rather than reserve managers and sovereign wealth funds as seen in the past. These private inflows reflect a 'latent' demand by investors to hold Chinese assets, motivated by the diversification benefits and the relatively high returns of Chinese assets. To date, investments in the bond market have been almost exclusively in sovereign (or quasi-sovereign) bonds because investors have been reluctant to take credit exposure to Chinese local governments or SOEs (Graph 13). These inflows could have much further to run if investors eventually match new benchmark weights (Lien and Sunner 2019).

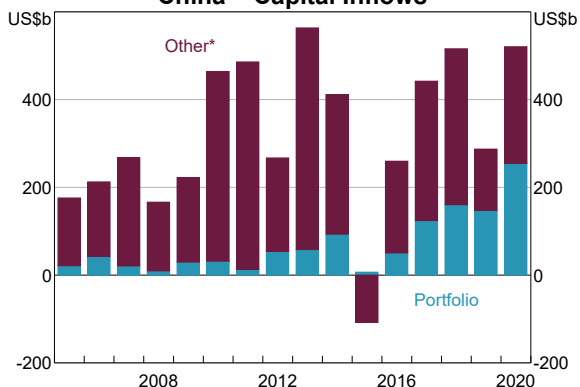
More freedom in the movement of private capital has been associated with more exchange rate flexibility. That has most recently been reflected in an appreciation, given the stronger recovery of the Chinese economy and the fact that controls on capital inflows have been eased more than those on outflows.

A key issue remains how far China will ultimately pursue an opening of its capital account. The size of foreign holdings of Chinese securities remains small compared with other economies. Indeed, the fact that debt in China continues to be owned mainly 'internally' (and in domestic currency) rather than by foreign investors gives the authorities considerable scope to control the pace of any deleveraging (Graph 14).

As well as gradually allowing more capital flows, the authorities have promoted the use of renminbi more widely outside China in both trade and finance. Greater international use of the renminbi would allow Chinese entities to conduct international trade and access foreign capital with less exchange rate risk and less exposure to potential stresses in the US dollar funding system (Windsor and Halperin 2018).<sup>[7]</sup> Those efforts have included setting up offshore centres for settling renminbi transactions, developing a pool of offshore renminbi deposits and providing liquidity backstops abroad with bilateral currency swap agreements.

**Graph 12**

**China – Capital Inflows**

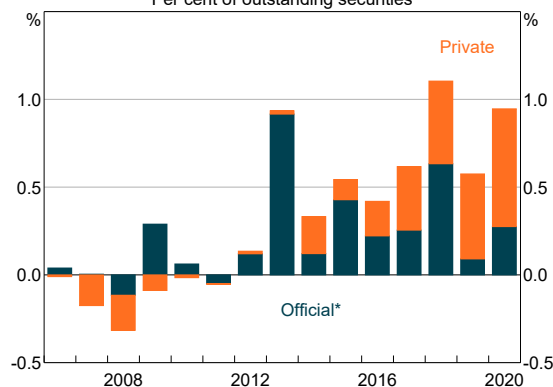


\* Includes direct investment and banking-related  
Source: CEIC Data

**Graph 13**

**Foreign Purchases of Chinese Government Debt Securities**

Per cent of outstanding securities



\* Includes central banks and international financial institutions  
Source: Sovereign investor base estimates by Arslanalp and Tsuda (2014)

## How is China's influence on the global financial system changing?

China has become increasingly important for the global financial system. There are three key aspects of this: China's excess of savings over investment (or relatedly, trade surpluses); China's increased integration with global trade; and China's increased integration with global capital markets and, relatedly, the international use of the renminbi. All three aspects have the potential to influence risk-free interest rates, exchange rates and risk premiums globally.

### Historically, China's influence on the global financial system was via sizeable capital outflows

China has long had domestic savings in excess of its domestic investment (Graph 15). China's remarkably high rate of savings is partly a result of its under-developed social safety net (IMF 2021a). This was exacerbated by financial restrictions, especially through the 2000s, which promoted export-led growth. To manage the exchange rate, savings were channelled abroad via the accumulation of foreign exchange reserves, which are invested in the debt of foreign governments. Some observers saw this 'savings glut' as contributing to a persistent decline in long-term, risk-free interest rates globally prior to the GFC (Bernanke 2005).

Since the mid 2000s, the difference between China's savings and investment has declined from

10 per cent of its GDP to about 1 per cent. The rate of saving has declined from very high levels as the economy has begun a transition towards higher levels of consumption. After the GFC there was also an increase in investment, which was associated with rapid growth in credit and related financial vulnerabilities.<sup>[8]</sup> In that regard, the decline in the extent of the 'external imbalance' has been associated with a rise in 'internal imbalance'.

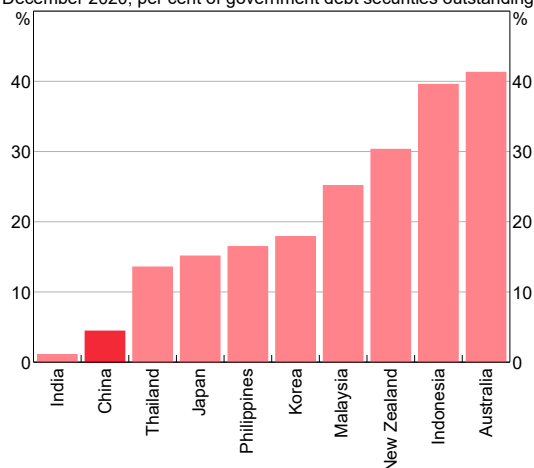
How far China exports net savings to the rest of the world in the coming years (if at all) will depend partly on how these internal imbalances are resolved. A return to reducing financial system risks could weigh on investment, which by itself would see external surpluses rise. But the authorities are also looking to continue to encourage other sources of domestic demand (i.e. consumption), which would lower the rate of savings, reducing the external surplus. Over a longer period, the ageing of the population and building out of the social safety net could also see the savings rate decline, which might even see China import savings from the rest of the world.

### China's large trade flows have given rise to indirect effects on global markets

China now plays a critical role in global trade, as both its imports and exports have grown as a share of the world economy (i.e. in *gross* rather than *net* terms). As a result, China's business cycle has become more important for other economies, affecting interest rates, profits and asset returns globally. In turn, it has had a growing *indirect* effect

**Graph 14**

**Asian Sovereign Debt – Foreign Ownership**  
December 2020, per cent of government debt securities outstanding\*

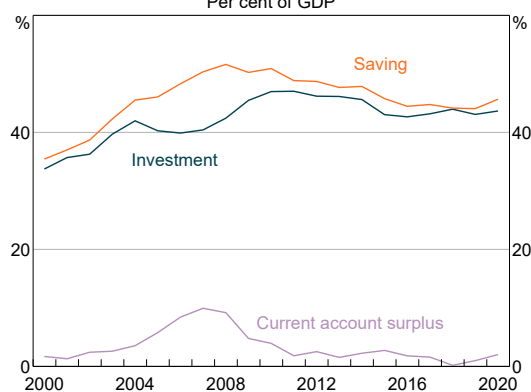


\* Includes central, state and local government debt

Source: Sovereign investor base estimates by Arslanalp and Tsuda (2014)

**Graph 15**

**China – Saving and Investment**  
Per cent of GDP



Source: IMF



on global markets, even while it has remained relatively closed financially.

That growing influence helps to explain the rising co-movements between Chinese and international markets. That is especially marked for equity prices, while co-movements with government bond yields remain lower (Graph 16). For example, the more positive outlook for China's economy over the past year has not only helped to lift equity prices in China but also abroad.

The renminbi now also moves more closely with a range of other currencies (not only the US dollar). This reflects the greater flexibility of the exchange rate to respond to developments in the Chinese and global economies. An improved outlook in China tends to place upward pressure not only on the renminbi, but also on the currencies of commodity exporters (e.g. Australia) and some other economies in Asia that are closely integrated with Chinese supply chains or seek to maintain their export competitiveness with China (Graph 17).<sup>[9]</sup>

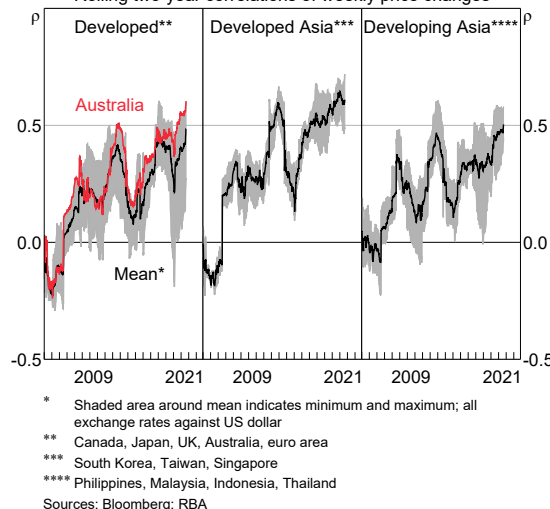
**China's direct links to the global financial system have begun to deepen**

As capital flows have been gradually liberalised, *direct* exposures to Chinese assets in the international financial system have risen. China's share of international portfolios has doubled over the past decade, while international banks' lending into China has also risen. However, the size of these links remains modest, at around 2 per cent of

international portfolios and 4 per cent of international banks' cross-border loans (Graph 18).

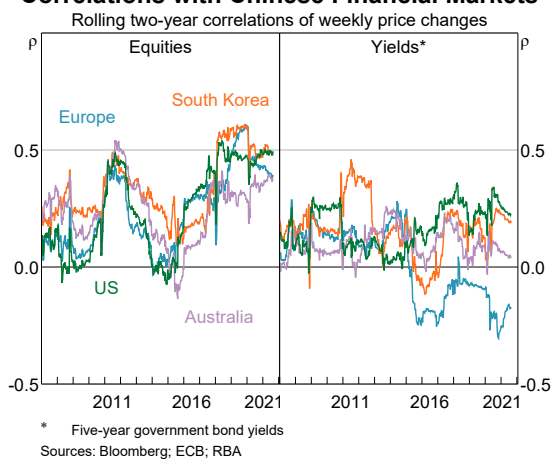
Meanwhile, China's investment abroad has widened in scope. In the past, this mainly took the form of investments by the state via its foreign exchange reserves. In recent years, direct investments abroad by private Chinese companies expanded significantly. However, from 2016 these slowed substantially, after authorities curtailed a wave of debt-funded acquisitions by Chinese corporations expanding outside of their core areas of business (McCowage 2018). There has also been some easing of restrictions on portfolio outflows, while bank-related outflows continue to play a significant role.

**Graph 17**  
**Exchange Rate Correlations with Renminbi**  
Rolling two-year correlations of weekly price changes



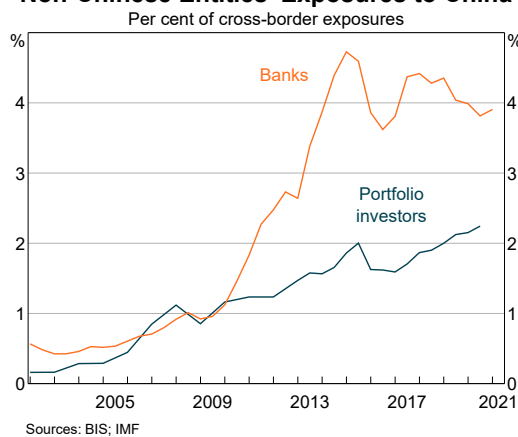
**Graph 16**

**Correlations with Chinese Financial Markets**



**Graph 18**

**Non-Chinese Entities' Exposures to China**



**China affects Australian financial conditions mainly because of its importance for trade**

China's effect on Australian financial markets has risen, as it has for many other economies. That reflects deep trade linkages, particularly in relation to Australia's resource exports. The Australian dollar moves more closely with the renminbi than do the currencies of many other advanced economies. That said, many Australian asset prices continue to move much more closely with those in the United States than those in China (Graph 19).

With capital flowing more freely across its borders, China has at times been a source of investment flows into Australia. China is a substantial investor in Australian government debt through its foreign exchange reserves. Chinese corporations have also made direct investments in Australia over the past decade or so, initially in the mining sector but more recently in a broader range of industries (Graph 20). Chinese direct investment in Australia declined in 2020, amid similar declines across other economies; however, it continues to account for a steady share of the stock of total foreign investment in Australia.

Australian investments in China were mainly banking-related in the past, while direct investment has been relatively small. However, Australian portfolio investments in China have become much more important in recent years as market access has improved.

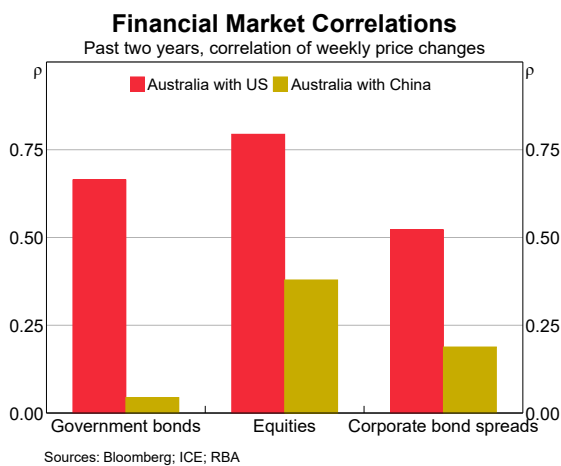
Overall, the size of these investments remains modest. China accounts for only 2 per cent of both foreign investment in Australia and of Australian

investment abroad (compared with around one-third of Australia's exports), and Australian investment in China has declined recently. More generally, advanced economies continue to account for over 80 per cent of foreign investment in Australia (Graph 21).

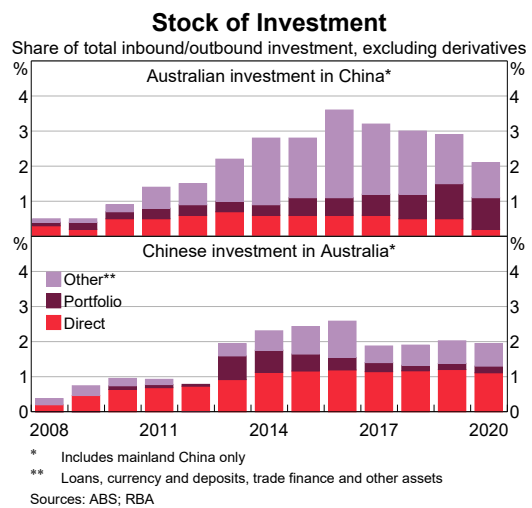
**The renminbi's role in the international financial system remains modest**

China's efforts to promote the wider international use of the renminbi have seen some limited progress. Most notably, a rising share of payments involving Chinese entities are in renminbi, recently as much as 40 per cent (Graph 22). That reflects increased foreign activity in Chinese securities markets (which are transacted in renminbi) and also

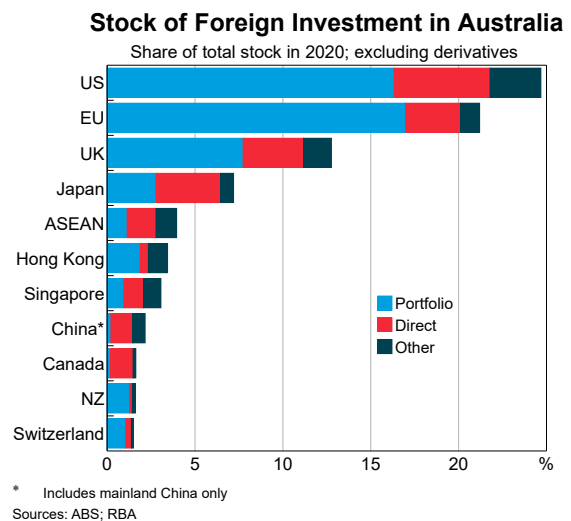
**Graph 19**



**Graph 20**



**Graph 21**



more of China's trade being invoiced in yuan (Windsor and Halperin 2018). But the wider international use of the renminbi (including between non-Chinese entities) remains small for both trade and investment, and well below use of the US dollar, euro and even the Japanese yen and UK pound sterling (Graph 23).

It remains to be seen how widely the renminbi will be adopted internationally. Some observers have suggested that a Chinese central bank digital currency ('an eCNY') might gain greater use internationally (BIS 2021; Feng 2021; Prasad 2020). This is currently a domestically focused project, with objectives similar to those highlighted by some other emerging market economy central banks

(such as improving domestic payments and widening financial inclusion). The Chinese authorities have played down the extent to which they expect the existence of an eCNY to drive international use of the renminbi. More generally, to the extent that the renminbi gains increased international use, this is most likely to occur within Asia given the region's integration into Chinese trade and production.

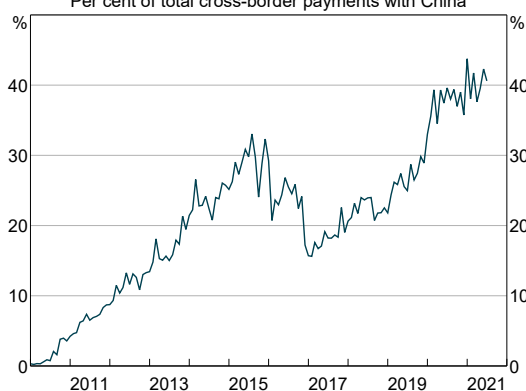
### Conclusion and outlook

Risks in China's financial system remain elevated despite its economy's strong recovery from the COVID-19 pandemic and the modest and targeted use of monetary stimulus. These risks will continue to shape its economic management in the years ahead, with implications for growth and, in turn, financial conditions in the global economy.

While China has become heavily integrated with the global trading system, its integration with global capital markets is still at a formative stage. It is unclear just how far and how quickly China will open further to international capital flows. The history of other economies suggests that there is merit in proceeding carefully. But China's large size means that any progress will make it much more important for the global financial system. While the scale and nature of this shift is difficult to predict, its importance can be illustrated by looking at what would happen if China's stock of portfolio positions (both inward and outward investments) were to reach 70 per cent of GDP – half that of the United States or Australia, but similar to South Korea. In that case, China would account for around 8 per cent of global portfolio investment, third behind the euro area and the United States (and compared with 1 per cent currently) (Graph 24).<sup>[10]</sup>

**Graph 22**

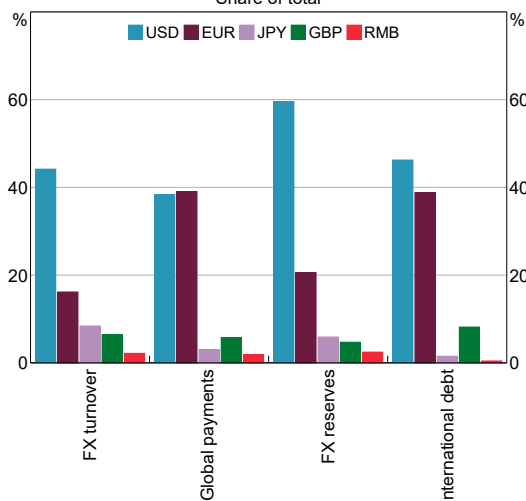
**International Payments with China in Renminbi\***  
Per cent of total cross-border payments with China



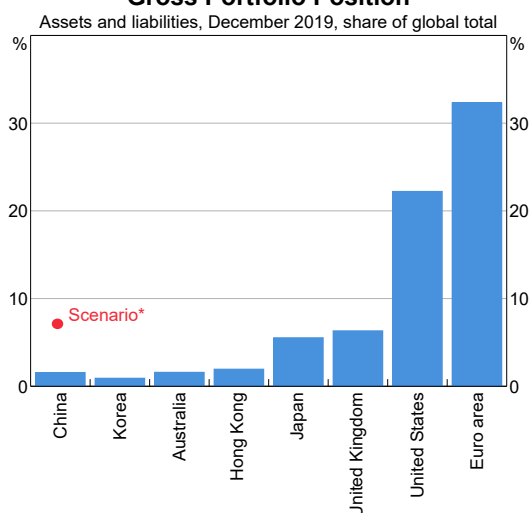
\* For Chinese non-financial sector  
Source: CEIC Data

**Graph 23**

**A Snapshot of International Currency Use**  
Share of total



Sources: BIS; IMF; SWIFT

**Graph 24****Gross Portfolio Position**

More generally, further opening would mean increased holdings of foreign assets by Chinese residents and increased holdings of Chinese assets by the rest of the world. That large rebalancing could affect asset prices and financial conditions differently across regions and markets. If this is a gradual process, it may prove relatively manageable. The renminbi could become a more widely used international currency, especially within Asia. Over time, financial conditions in Australia are likely to be increasingly influenced by the news in Shanghai and Shenzhen alongside New York and London. ✎

## Footnotes

- [\*] The authors completed this work in International Department. The authors would like to thank Morgan Spearritt and Ewan Rankin for their extensive help in preparing this article. Serena Alim, Tim Atkin, John Boulter, Iris Day, Eden Hatzvi, Jarkko Jaaskela, Diego May and Ivan Roberts also provided valuable input and feedback.
- [1] See, for example, Bowman, Hack and Waring (2018).
- [2] In its recent 'Article IV Report for China', the International Monetary Fund (IMF) considers the challenges to China's reform process, as well as opportunities for further development. See IMF (2021a) for more details.
- [3] This has been reinforced by a range of other policies that restrict the availability of credit for riskier borrowers.
- [4] One earlier reason for interest rate controls also diminished over time – namely, to help recapitalise the banking system (by artificially lifting net interest margins) after a severe rise in non-performing loans in the late 1990s.
- [5] Policy interest rates have remained well above zero, and so the PBC has not purchased government securities to lower long-term interest rates further.
- [6] The 'connect' schemes enable cross-border portfolio investment, between exchanges in Hong Kong and China as well as London and China. While no launch dates have been specified, additional schemes enabling mainland investment in the Hong Kong bond market and two-way investment in wealth management products are expected in the near future.
- [7] For a recent analysis of the international role of the US dollar, see Prasad (2019).
- [8] From a trade perspective, the decline in the current account surplus reflected a substantial appreciation of the exchange rate, a natural slowing in China's penetration of export markets and a rise in tourism imports.
- [9] Statistical methods that identify co-movement with the renminbi more precisely (by abstracting from the common effect of US dollar movements on all exchange rates) also show a rising relationship with exchange rates of other Asian economies (Windsor and Halperin 2018).
- [10] See Cunningham, Hatzvi and Mo (2018) for an alternative counterfactual analysis of the removal of restrictions on China's portfolio outflows.

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