



THE CHANGING LANDSCAPE OF CHINA'S FINANCIAL SYSTEM

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CHINA'S INTEGRATION INTO THE GLOBAL ECONOMY

- 11.4% of global goods trade in 2017
- 2nd largest source of outbound FDI and recipient of inbound FDI from 2015-7
- Impactful in the global technology chain. Second highest in R&D spending in 2018

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WITH INTEGRATION

COMES THE

EXPOSURE TO RISK

CHINA'S INTEGRATION INTO THE GLOBAL ECONOMY

- Despite the trade frictions, China continues to pursue integration, in particular the integration into the global financial market
 - Financial system remains largely closed. Foreign ownership accounts for 2% (2%, 6%) in the Chinese banking (bond, stock) sector.
- This talk: a close look at the recent initiative of financial sector opening. Risk? Opportunity?

A BIT OF BACKGROUND

- 40 years of foreign access starts from “the formation of joint venture with certain foreign capital” (People’s Daily, 6/28/1979)
- April 10, 1980: Beijing Air Catering Ltd was born, nicknamed “China’s 001 James Wu” by Takungpao (大公报)

- The story of a “hand-shake” told by the daughter of James Wu, Annie Wu, SBS, JP



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- April 10, 1980: Beijing Air Catering Ltd was born, nicknamed “China’s 001 James Wu” by *Takungpao*
- In 1995, the first edition of *Catalogue of Industries for Guiding Foreign Investment* was released: encouraged, restricted, prohibited, and permitted
- In 2017, the *Catalogue* was replaced by a “negative list” approach

A BIT OF BACKGROUND

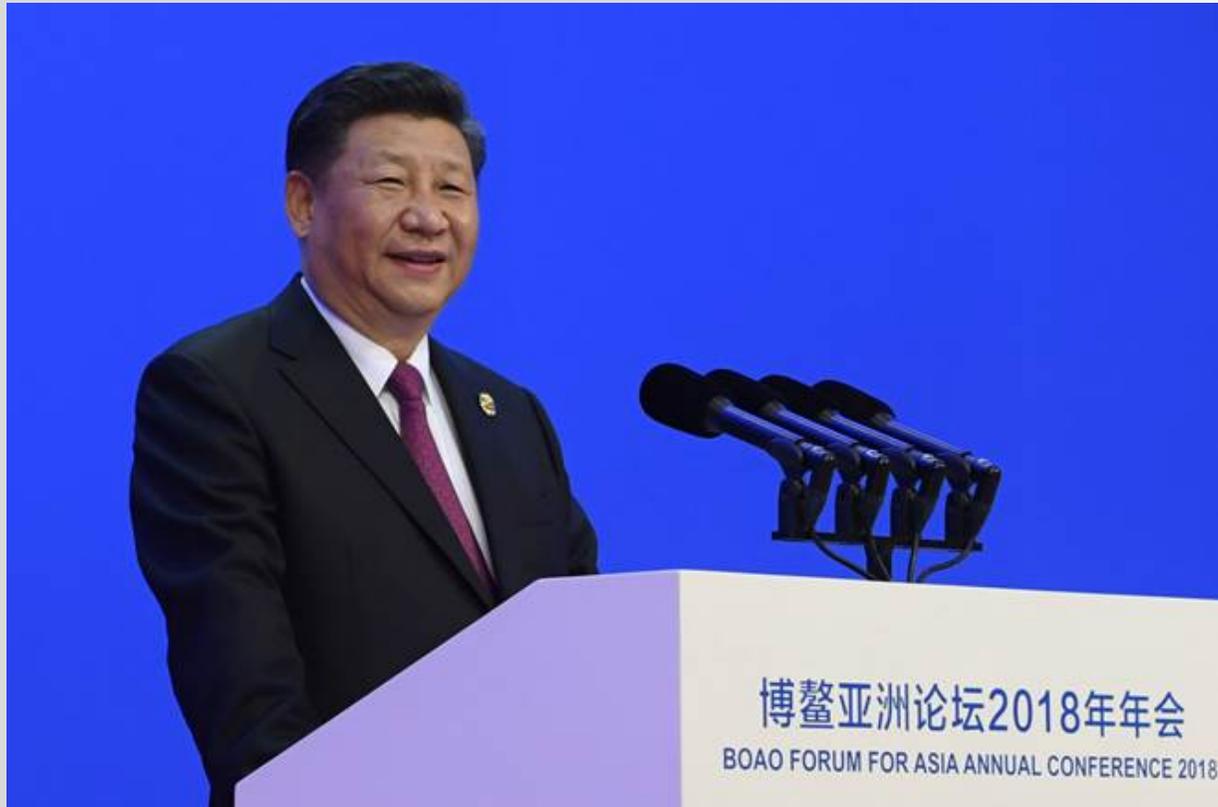
- The idea of the “negative list” approach: to emphasise deviations from national treatment.
- Types of foreign investment not mentioned on a negative list are to be given “national treatment” and may bypass the MOC’s foreign investment approval process and simply file for the record.
- The key changes from the 2017 to 2018 negative list concerns the financial sector.

Industry	2017 Negative List	2018 Negative List
Banking	<ul style="list-style-type: none">➤ Foreign shares of a commercial bank ≤20% (single investor).➤ Foreign shares of a commercial bank ≤25% (multiple investors).➤ Only foreign banking institutions may invest in rural small-to-medium financial institutions.➤ Only foreign commercial banks may be the sole or controlling shareholder of an FIE bank.	Removed

Industry	2017 Negative List	2018 Negative List
Securities	<ul style="list-style-type: none"> ➤ Foreign shares of a securities company $\leq 50\%$. ➤ Foreign shares of securities investment fund management company $\leq 50\%$. ➤ Scope of business initially is restricted to underwriting and sponsorship of RMB ordinary shares, foreign shares and government bonds, and corporate bonds; brokerage of foreign shares; brokerage of and investment in government and corporate bonds. ➤ Scope of business can be extended after 2 years upon application. 	<ul style="list-style-type: none"> ➤ Foreign shares of a securities company $\leq 51\%$. ➤ Foreign shares of a securities investment fund management company $\leq 51\%$. ➤ To be removed in 2021.

Industry	2017 Negative List	2018 Negative List
Insurance	<ul style="list-style-type: none"> ➤ Foreign shares of life insurance companies $\leq 50\%$. 	<ul style="list-style-type: none"> ➤ Foreign shares of life insurance companies $\leq 51\%$ ➤ To be removed in 2021.
Futures	<ul style="list-style-type: none"> ➤ Foreign shares of futures companies $\leq 50\%$. 	<ul style="list-style-type: none"> ➤ Foreign shares of futures companies $\leq 51\%$. ➤ To be removed in 2021.

COMMITMENT OF FINANCIAL OPENING ANNOUNCED WITH MUCH FANFARE



Xi Jinping @ Boao Forum 2018. Outlined the commitment preceding the publication of the list



Li Keqiang @ Dalian, World Economic Forum 2019. Limits to be abolished in 2020

WHAT DO THESE COMMITMENTS MEAN?

- Lower entry barriers to the financial sector for foreign banks, security companies, asset management companies, and insurance companies
- Higher autonomy for foreign companies when operating in China

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- Is the opportunity worth the risk?

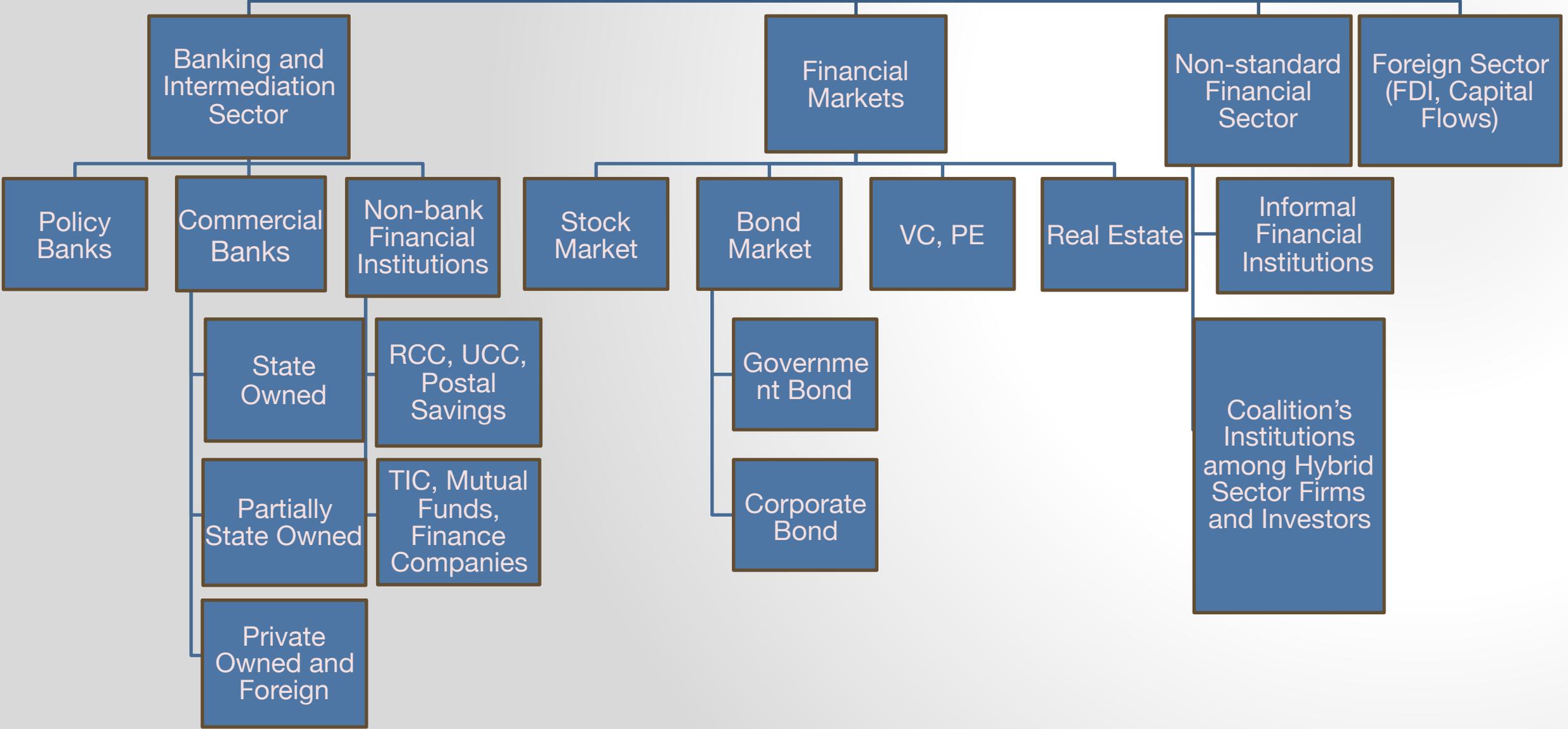
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- Lower entry barriers to the financial sector for foreign banks, security companies, asset management companies, and insurance companies
- Higher autonomy for foreign companies when operating in China
- Is the opportunity worth the risk?
- What is the current state of the financial system in China?
- What concrete measures have been taken?
- What remains an obstacle to foreign access?

CURRENT STATE OF THE CHINESE FINANCIAL SYSTEM

- The formal financial sector is bank-dominated and banks are state-dominated
- Major development in the bond market, but inefficiency is prevalent
- The non-standard financial sector is being brought under scrutiny and regulation
- Overall, the Chinese financial sector is still relatively closed with limited capital mobility.

China's Financial System



CURRENT STATE: BANK DOMINATION

Average over 2011-2017

	Bank credit to GDP	Market cap. to GDP	log(Market cap/Bank credit)
China	1.30	0.54	-0.93
EM excl. China	0.48	0.65	0.13

EM include: Argentina, Brazil, China, India, Indonesia, Malaysia, Mexico, Pakistan, Peru, Phillipines, Russia, S Africa, Sri Lanka, Thailand, and Turkey.

Demirgüç-Kunt, Čihák, feyen, Beck and Levine, Financial development and structure dataset 2018

CURRENT STATE: BANK DOMINATION

	2003		2015	
	Total assets (bn RMB)	%	Total assets (bn RMB)	%
State owned policy banks	2,125	7.68	19,285	9.67
State owned commercial banks (large)	16,051	58.03	78,163	39.21
Joint stock commercial banks	2,960	10.70	36,988	18.55
City commercial bank	1,462	5.29	22,680	11.38
Rural commercial bank	39	0.14	15,234	7.64
Rural credit cooperatives	2,651	9.58	8,654	4.34
Rural financial institution and postal savings bank	898	3.25	8,302	4.16
Others	1,473	5.32	10,039	5.04
Total	27,658	100.00	199,345	100.00

Jiang and Yao, "Chinese Banking Reform", The Nottingham China Policy Institute Series 2017

CURRENT STATE: STATE BANK DOMINATION

- By 2010, the overhaul of the big state-owned commercial banks was completed. All transformed into public banks with a diversified shareholding structure.
- Main financier of the state sector.
- Since 2011, policy shifted to “inclusive finance”: small/medium sized banks, private banks, internet finance...
- Non-bank financial intermediaries finance the private sector.

CURRENT STATE: A GROWING BOND MARKET

- Subnational government bond market grew as a result of the debt-swap program in 2014

(trillion RMB, unless o/w stated)	2013	2014	2015	2016	2017
Government Debt Outstanding	9.5	25.0	25.5	27.3	29.9
(Percent of GDP)	16.0	38.8	36.9	36.7	37.7
Of which: central government	8.7	9.6	10.7	12.0	13.5
Of which: local governments	0.9	15.4	14.8	15.3	16.5
(Percent of GDP)	1.45	23.9	21.5	20.6	20.9

Lam and Wang, "China's local government bond market", IMF 2018

CURRENT STATE: A GROWING BOND MARKET

- Relative to OECD countries, the size of China's subnational government bond market is large.

	Subnational government bond risk premium (basis points)	Growth rate	Debt/GDP
Australia (1990-2010)	75.2	7.8	3.8
Canada (1990-2010)	61.4	4.9	28.2
Germany (1990-2010)	18.9	2.3	25.2
US (1990-2010)	-43.6	3.7	6.9
China (2013-7)	10.7	7.7	24.6

Lam and Wang, "China's local government bond market", IMF 2018

CURRENT STATE: A GROWING BOND MARKET

- But subnational government bond pricing is not elastic to fundamentals, with minimal spreads across provinces (within 10-20 basis points).

Dependent variable: Subnational government bond spreads	Australia	Canada	Germany	US	China
Subnational government GDP growth	0.4	-0.7	1.7*	1.1	0.18
Subnational government fiscal balance/GDP	-6.7***	-6.4***	-0.8	-4.2***	0.00
Subnational government debt/GDP	0.7	0.1	-0.5	31.7***	-0.04
Liquidity	-3.3	-0.5	-2.9	-35.8***	-2.50***
Volatility	-0.7***	-0.3	-0.7*	2.5***	—
R squared	0.3	0.6	0.2	0.6	0.20

Lam and Wang, "China's local government bond market", IMF 2018

CURRENT STATE: A GROWING BOND MARKET

- The Chinese bond market is growing rapidly
 - Fast growth of the subnational government bonds
 - Fast growth of the non-state corporate bonds
- Challenges to the bond market development
 - Segmented markets (interbank, exchanges, bank counters) and regulatory framework

FRAGMENTED MARKET AND REGULATORS

Types of non-governmental Chinese bond issues

	Regulators	Issuing approval	Trading venues	Issuers
Enterprise bonds	NDRC	Permission from NDRC	Exchange and interbank markets	Non-financial institutions, mostly SOEs and non-listed firms
Corporate bonds	CSRC	Permission from CSRC	Exchange	Non-financial institutions, mostly listed firms
Medium term notes	PBOC	Registration with PBOC	Interbank market	Non-financial institutions
Financial bonds	PBOC	Permission from PBOC	Interbank market	Banks, finance companies, and other financial institutions

Livingston, Poon, Zhou, "Are Chinese credit ratings relevant?" *Journal of Banking and Finance*, 2018.

CURRENT STATE: A GROWING BOND MARKET

- The Chinese bond market is growing rapidly
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 - Fast growth of the non-state corporate bonds
- Challenges to the bond market development
 - Segmented markets (interbank, exchanges, bank counters) and regulatory framework
 - Ad hoc bailouts and rare defaults (5 in 2014, 21 in 2015, 30+ in 2016)
 - Underdeveloped market discipline. Problems with credit ratings and disclosure requirements

UNDERDEVELOPED MARKET DISCIPLINE

- Livingston, Poon and Zhou (2018) use a large sample of newly issued public bonds from 2009 to 2015 to show that, more than half of the bonds are rated AA and less than 4% are rated AA-

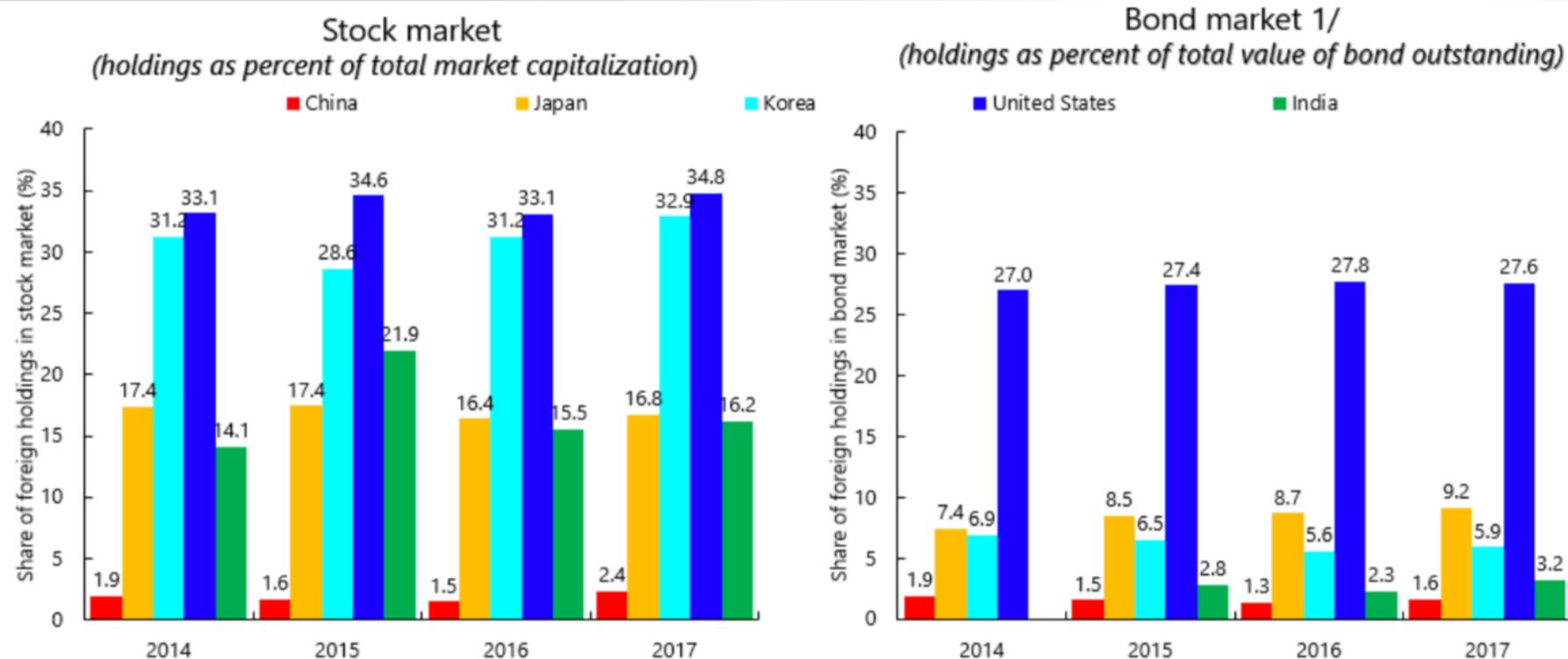
Chinese sample

Credit rating	AAA	AA+	AA	AA-
Spread	1.517%	2.410%	3.052%	3.326%

Merrill Lynch Global Corporate Bond Index

Credit rating	AA	A	BBB	BB
Spread	1.09%	1.61%	2.45%	4.60%

CURRENT LEVEL OF OPENNESS: STOCK AND BOND MARKETS



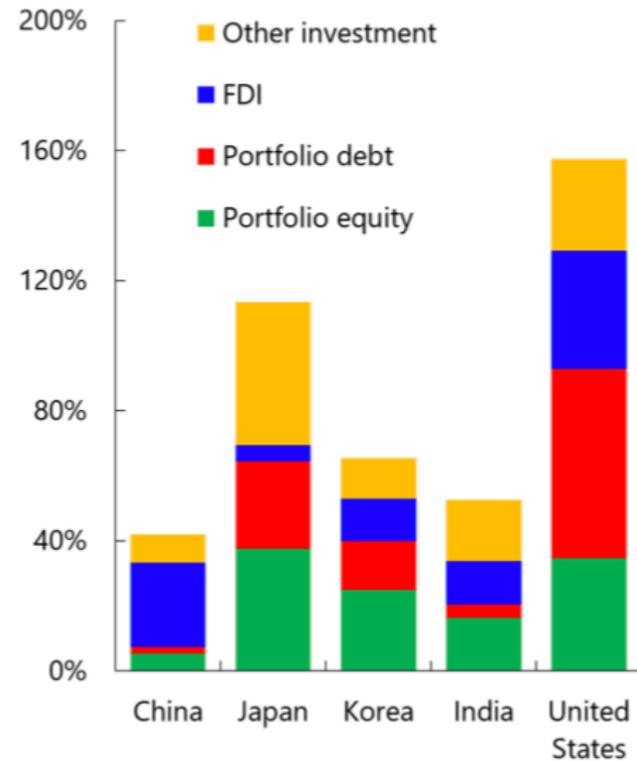
Sources: Bank of Japan; CEIC; Financial Supervisory Service; Financial Supervisory Service, Korea; Haver Analytics; Ministry of Finance, Japan; People's Bank of China; Reserve Bank of India; SIMFA; U.S. Department of Treasury; and IMF staff calculations.

1/ Data for India only includes government securities.

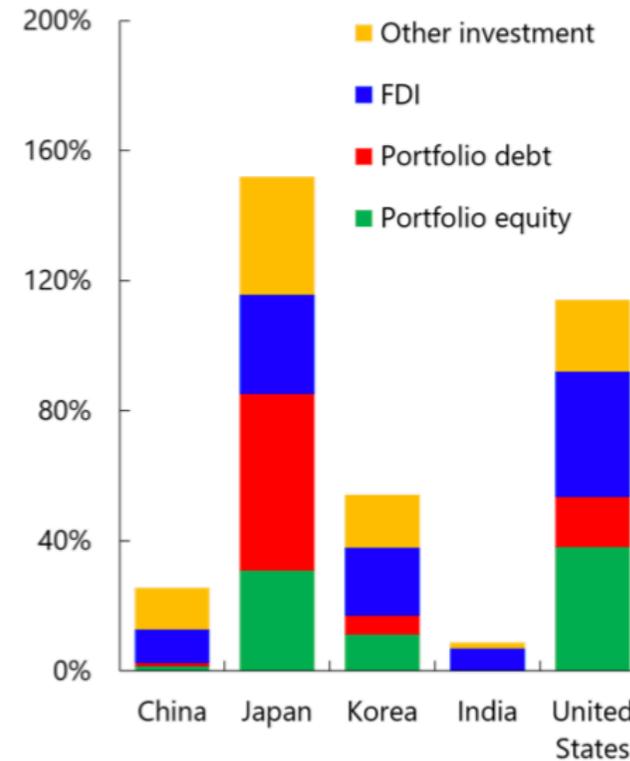
Cross-country comparison of foreign participation in financial markets. Cerutti and Obstfeld (2018, IMF Working Paper)

CURRENT LEVEL OF OPENNESS: INTERNATIONAL INVESTMENT POSITION

IIP liabilities, 2015 (percent of GDP)



IIP assets, 2015 1/ (percent of GDP)



Sources: Lane and Milesi-Ferretti (2017); IMF, *Balance of Payment Statistics*; and IMF staff calculations.
1/ Net of reserves.

International investment position. Cerutti and Obstfeld (2018, IMF Working Paper)

RECENT OPENING-UP MEASURES

- Highly publicised
- Multi-sectoral
- Gradualist

RECENT OPENING-UP MEASURES

- November 2014: Shanghai-HK Stock Connect launched that allowed investors in each market to trade shares on the other market using their local brokers and clearing houses subject to quotas.
- February 2016: China Interbank Bond Market (CIBM) Direct Scheme announced to allow foreign institutions to trade onshore bonds through banks holding a Type A licence in mainland China.

RECENT OPENING-UP MEASURES

- 2017: Bond Connect Program launched in HK.

Date	Channel	Quota (Size)	Application procedure	Timing
2002	QFII	Yes (US 80 bn)	Registration & PBoC approval	12-18 months
2011	RQFII	Yes (US 70 bn)	Registration & PBoC approval	12-18 months
2016	CIBM	Unlimited	Filing only	2 months
2017	Bond Connect	Unlimited	Filing only	2-4 weeks

Source: State Street Opening of China's Bond Market (2018).

RECENT OPENING-UP MEASURES: BANKS AND AMCS

Aug 2018

Foreign ownership caps on banks and financial asset management companies were removed.

Oct 2019

CSRC announced the official removal of foreign ownership caps in fund managers from 1 Apr 2020. The State Council further revised regulation on foreign banks to allow them to establish branches and subsidiaries at the same time, and to take time deposit of 0.5 mn yuan per transaction, down from the previous 1 mn yuan minimum.

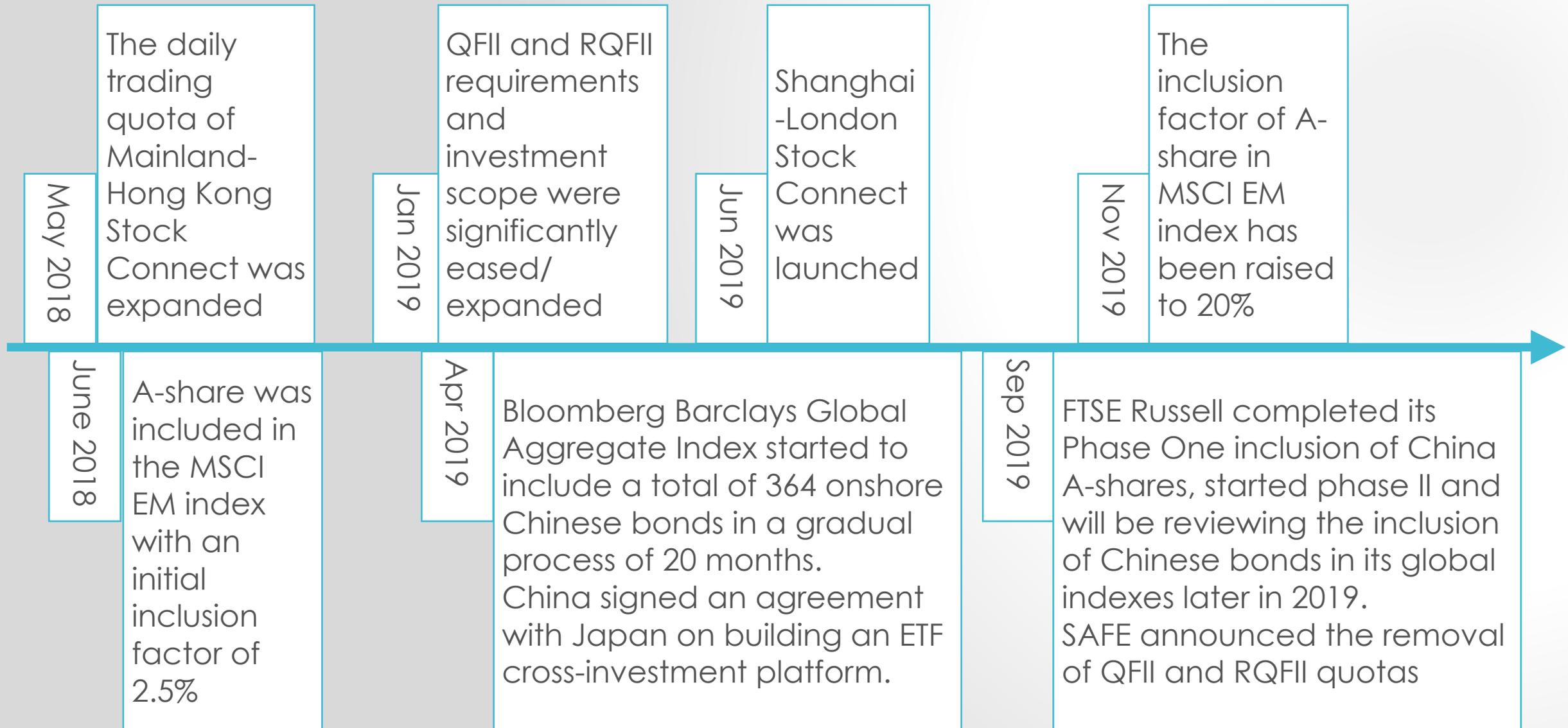
May 2019

CBIRC pledged to unveil 12 new measures for the opening of the Chinese banking sector. Key changes include removing the requirement of asset level for foreign banks to set up a legal entity or local branch in China and removing approval procedures for foreign banks to conduct RMB business

RECENT OPENING-UP MEASURES: BANKS AND AMCS

- Dec 2018: UBS increased its shareholding in UBS Securities to 51%, becoming China's first foreign-funded securities firm
- Bank of Beijing and ING Bank announced they are setting up a joint venture in March, marking the first foreign-controlled bank
- Morgan Stanley bought an additional 5.5% equity in its China mutual fund joint venture, becoming the top shareholder

RECENT OPENING-UP MEASURES: MARKETS



RECENT OPENING-UP MEASURES: MARKETS

- China A shares only account for 4% of MSCI Emerging Markets Index.
- Further inclusion on hold until conditions are met:
 - Provide access to hedging and derivatives instruments
 - Align China's settlement cycle shorter than that in other large markets
 - Align trading holidays on the on- and off-shore markets

RECENT OPENING-UP MEASURES: OTHER SECTORS

Brokerages, futures, insurers

Juli 2019
China announced it would fully remove foreign ownership caps by 2020

Oct 2019
CSRC announced to remove the foreign ownership caps in brokerages, futures and insurers on Dec 1, Jan 1, Apr 1 in 2020.

Rating agencies and laws

Juli 2017
Rating agencies were allowed to be wholly controlled by foreign investors

Mar 2019
New foreign investment law passed the NPC and will come into effect on Jan 1, 2020

RECENT OPENING-UP MEASURES: OTHER SECTORS

- Jan 28, 2019: S&P Global became the first foreign credit rating agency approved to rate China's domestic bonds
- March 2019: Standard Life Aberdeen and Tianjin TEDA secured approval to set up a joint venture, Heng An Standard Life, China's first foreign-Chinese pension insurance business.
- August 2019: Nomura Orient International Securities was set up, becoming the first newly established securities firm in which foreign investors have a controlling stake.
- November 2019: Allianz (China) Insurance Holding Co. Limited was approved to become the first wholly foreign-owned insurance holding company.

REMAINING PROBLEMS

- Foreign direct investment
 - Enter as a wholly foreign-owned. Licensing, product approval
 - Team up with the local. Intervention
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- Foreign portfolio investment
 - Derivatives product approval
 - Trading restrictions
 - Short sale constraints

THE CHINESE POINT OF VIEW

- Balance between opening-up and managing “risks posed by foreign investors to China”
- Lessons from the Asian financial crisis and the Global financial crisis
- Preference of FDI over FPI to have “skin in the game”

THE CHINESE POINT OF VIEW

- Fundamental economic model is still state capitalism
- Regulation of the domestic financial system still work in progress
- Stability, Stability, Stability
- Sequence of reform is a delicate issue

CONCLUSION

- China is making its financial market more open to foreign investors in a gradual way
- This is an important policy objective if China wants to promote the international use of RMB
- With integration comes risks: it works both ways!
- Incentive compatible path of integration