How Open Are China's Capital Markets to Foreign Investment?

Shanghai, China

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The current stock market correction in China is serving as a useful test of the commitment of policymakers to maintaining recent financial reforms in the face of financial volatility.

China has historically exerted tight control over foreign capital flows. However, a series of somewhat unheralded financial reforms over the past several years have opened up the financial system to a significant degree. The current stock market correction is serving as a useful test of the commitment of Chinese policymakers to maintaining these reforms in the face of financial volatility.

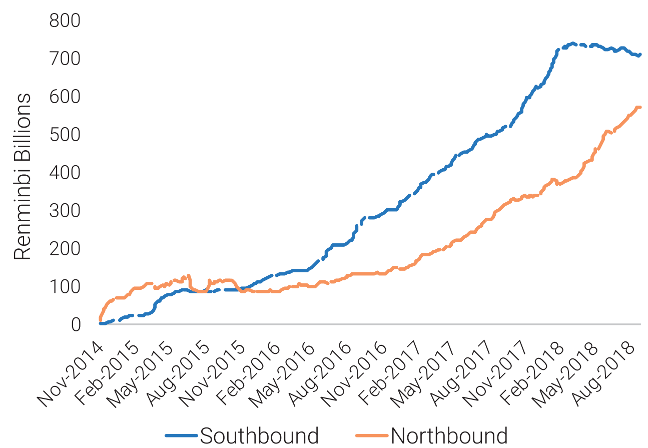
Opening Up the Stock Market

The Shanghai-Hong Kong Stock Connect program was established in 2014 and allows northbound and southbound purchases of the majority of the market cap listed on the Hong Kong and Shanghai Stock Exchanges. The program was launched with both a daily quota and an aggregate quota that put maximum limits on the dollar value of shares that could be purchased through the stock connect. Initial participation was limited as investors grappled with operational hurdles impacting the new program.

A follow-up program, the Shenzhen-Hong Kong Stock Connect, was launched in 2016 and provides foreign investors with access to many of the high growth technology firms listed in Shenzhen. At the same time as the launch of the Shenzhen Connect, authorities removed the aggregate quota for both stock connect programs. In April 2018, the daily quota amount for the stock connects was quadrupled. Figure 1 shows the accumulated net inflows of the stock connect programs since inception.

While direct market access increased after the creation of the stock connects, share suspensions remained a major source of concern for foreign investors. At the height of China's stock market crash in 2015, more than half of listed shares were suspended from trading.[1] Foreign investors seeking to redeem their investments faced long waiting periods for many stocks before trading resumed. The Shanghai and Shenzhen Stock Exchanges have subsequently adjusted their share suspension rules, leading to a decline in the number of suspended shares.

Figure 1 – China Stock Connect Accumulated Net Inflows
11/17/14 – 9/11/18



Source: Wind Information.
Includes the Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect.

Prevailing Winds is a China-focused blog written by Nicholas Borst, Director of China Research at Seafarer. The blog tracks the economic and financial developments shaping the world's largest emerging market.

China enacted many of these reforms in the hope of securing the inclusion of A-shares in the MSCI Emerging Markets Index, which is tracked by many of the world's largest global investors. In the eyes of Chinese policymakers, entering the index represents an international stamp of approval for the country's capital market reforms and has the potential to bring about a substantial inflow of capital. These efforts paid off when MSCI announced the partial inclusion of A-shares in 2017, which went into effect in May 2018. Chinese policymakers are currently striving for a higher inclusion rate in the MSCI index and for A-shares to enter the FTSE Russell Global Index. Planning for a third stock connect program, the Shanghai-London Stock Connect, is currently underway, with draft rules by Chinese regulators published at the end of August 2018.

Opening Up the Bond Market

Reforms to the bond market have been another significant factor in opening up the financial system to foreign investment. In 2015, foreign central banks and sovereign wealth funds were given direct access to the interbank market, the main venue for bond trading in China. This access was expanded in 2016 to include institutional investors, foreign banks, insurance companies, and securities companies. Altogether, more than 1,000 foreign institutional investors have now invested in the Chinese interbank market.[2]

A further opening of the bond market occurred in 2017 with the creation of the Bond Connect program. Similar to the stock connect programs, the bond connect allows cross-border access for investors in Hong Kong and China. However, unlike the stock connects, the bond connect only allows northbound trading (inflows into China) for now. The bond connect program has grown steadily since its creation. As of July 2018, 391 institutional investors have registered to use the program, and 34 banks and securities companies act as participating dealers.[3] Average daily turnover now exceeds 3.7 billion renminbi (RMB), with buy trades accounting for two-thirds of the total volume.[4] The bond connect recently implemented a real-time delivery versus payment (RDVP) system, a key prerequisite for many investors to utilize the program.

Many of China's bond market reforms were enacted as part of the effort to secure inclusion by the International Monetary Fund (IMF) of the renminbi in the Special Drawing Rights (SDR) currency basket, a status reserved for a select few international currencies. To achieve inclusion, a currency must be deemed to be "freely usable" by the IMF, as evidenced by wide use in payments for international transactions and significant trading volume in the principal exchange markets.[5] Operationally, a currency must be free enough to be used as part of IMF programs and reserve management by members. The IMF announced inclusion of the renminbi in the SDR in November of 2015, which went into effect in October of 2016. These reforms have been rewarded by global bond index providers with the greater inclusion of the Chinese bond market in global indexes.

Widening Institutional Investor Programs

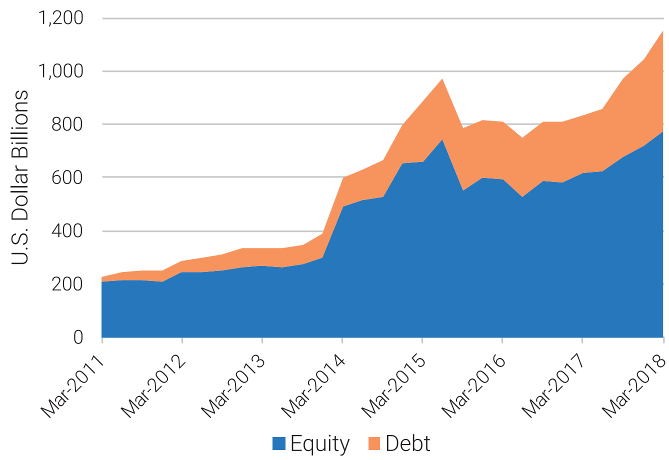
A decade before the stock and bond connect programs, China began establishing cross-border programs for institutional investors. The Qualified Foreign Institutional Investor (QFII), Qualified Domestic Institutional Investor (QDII), and Qualified Domestic Limited Partnership (QDLP) programs allow cross-border investments, subject to quotas and lockup requirements. In 2016, reforms were implemented to the QFII program to make it more flexible and attractive. The initial lockup period was reduced from one year to three months, the frequency of allowable redemptions was increased to daily, and the quota approval process was streamlined. Further reforms were made in 2018 when the 20 percent monthly redemption cap was removed, the initial lockup period was eliminated, and QFII funds were allowed to hedge currency risks in the onshore market.[6] Progress for outbound investment has been more limited. The QDII and QDLP programs resumed in 2017 and 2018, respectively, after being unofficially suspended during the 2015 stock turmoil.

Testing Commitments

Overall, these reforms have led to a significant increase in foreign portfolio inflows into Chinese capital markets over the past few years. Figure 2 shows the growth of both equity and debt holdings during this period.

While important, these reforms will amount to little if they are abandoned at the first sign of financial volatility. The arbitrary nature of government intervention during the 2015 stock market crash undermined confidence in China's markets and led to fears that liquidity channels could be closed at a whim. Chinese policymakers have worked hard to restore confidence and demonstrate a commitment to reform and openness. The current sharp downturn in China's equity market, during which A-shares are down more than 20 percent from their peak earlier this year, is proving to be a useful test of these commitments.[7] Along with the slide in the stock market, the currency has depreciated significantly and the U.S.-China trade war continues to damage market sentiment. If large capital outflows occur or the sell-off in the stock market becomes a collapse, the likelihood of intervention will be high. Short of these scenarios, Chinese policymakers have displayed a greater tolerance for financial volatility than in the past. If this acceptance of volatility continues, it will mark a new and more mature period for China's capital markets.

Figure 2 – Foreign Portfolio Investment in China 3/2011 – 3/2018



Source: Wind Information.

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[1] Emma Dunkley, "Chinese stock suspensions a 'visceral' issue for investors," *Financial Times*, 4 June 2018. https://www.ft.com/content/cb84f678-67bc-11e8-8cf3-0c230fa67aec

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[3] "Northbound Bond Connect – List of Participating Dealers," Bond Connect, 3 July 2018. http://www.chinabondconnect.com/documents/Participating_Dealers.pdf

[4] "Flash Report for Bond Connect – July 2018," Bond Connect, 10 August 2018. http://www.chinabondconnect.com/documents/FlashReportforBondConnect-July2018.pdf

[5] "Q and A on 2015 SDR Review," International Monetary Fund, 30 November 2015. https://www.imf.org/external/np/exr/faq/sdrfaq.htm#four

[6] Alun Jonh and Samuel Shen, "China Eases QFII Foreign Investment Rules in Boost to Channel Use," *Reuters*, 12 June 2018. https://www.reuters.com/article/us-china-investment-qfii/china-eases-qfii-foreign-investment-rules-in-boost-to-channel-use-idUSKBN1J81I1

[7] Wind Information. Accessed 28 August 2018.

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Glossary

Bond Connect: a market trading link that allows certain investors from Mainland China and overseas to trade in each other's bond markets through a special mechanism that was designed and implemented by the Hong Kong Stock Exchange. Currently, only Northbound trading is allowed, meaning that foreign investors are able to buy and sell Chinese bonds. Chinese investors are not yet able to trade Hong Kong and overseas bonds, known as Southbound trading.

Chinese A-Shares: a class of securitized common stock in Chinese companies, traded exclusively on Chinese stock exchanges (i.e., Shanghai and Shenzhen), and denominated in renminbi, China's currency. Historically, A-shares were inaccessible to foreign investors, but more recently China has allowed foreign investors to purchase A-shares through the Qualified Foreign Institutional Investor (QFII) program and the Stock Connect programs.

Interbank Market: a foreign exchange market where banks trade currencies.

International Monetary Fund (IMF): an organization of countries whose primary purpose is to ensure the stability of the international monetary system—the system of exchange rates and international payments that enables countries (and their citizens) to transact with each other. Created in 1945, the IMF is governed by and accountable to the countries that make up its near-global membership.

Qualified Domestic Institutional Investor (QDII): a program that permits certain licensed Chinese institutional investors to invest in global capital markets, subject to a quota.

Qualified Domestic Limited Partnership (QDLP): a program that permits certain licensed Chinese institutional investors to participate in private funds that invest overseas, subject to a quota.

Qualified Foreign Institutional Investor (QFII): a program that permits certain licensed global institutional investors to participate in China's renminbi-based mainland capital markets, subject to a quota.

Real-time Delivery Versus Payment (RDVP): a securities industry settlement procedure in which payment and delivery of securities occur at the same time, reducing or eliminating settlement risk by the counterparties of a trade.

Renminbi (RMB): the official currency of the People's Republic of China. The name literally means "people's currency." The yuan (sign: ¥) is the basic unit of the renminbi, but is also used to refer to the Chinese currency generally, especially in international contexts.

Special Drawing Rights (SDR): an international reserve asset created by the International Monetary Fund in 1969 to supplement its member countries' official reserves. SDRs can be exchanged for freely usable currencies.

Shanghai-Hong Kong Stock Connect: a trading link launched in 2014 that allows offshore, non-domestic-Chinese investors and entities to invest in Chinese A-shares listed on the Shanghai Exchange. Investment via the stock connect occurs through a special mechanism that was designed and implemented by the Hong Kong Stock Exchange. The stock connect also allows Mainland China investors to purchase certain Hong Kong-listed stocks via accounts with the Shanghai Exchange.

Shenzhen-Hong Kong Stock Connect: a trading link launched in 2016 that allows offshore, non-domestic-Chinese investors and entities to invest in Chinese A-shares listed on the Shenzhen Exchange. Investment via the stock connect occurs through a special mechanism that was designed and implemented by the Hong Kong Stock Exchange. The stock connect also allows Mainland China investors to purchase certain Hong Kong-listed stocks via accounts with the Shenzhen Exchange.

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The MSCI Emerging Markets Total Return Index is a free float-adjusted market capitalization index designed to measure equity market performance of emerging markets. The FTSE Russell Global Index is a free float-adjusted market capitalization index designed to include all companies around the world that meet certain size and investability standards. It is not possible to invest directly in an index.