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Two decades of economic transformation in China

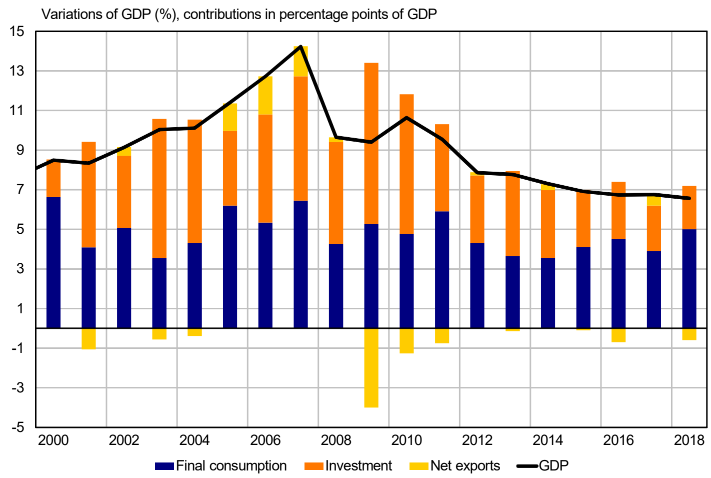
- China experienced major economic changes during the two decades leading up to the recent COVID-19 pandemic. It has become one of the cornerstones of the world economy and its emergence in the noughties was driven by a growth model based on investment and integration in global value chains. After very strong real growth averaging 10% per year between 1980 and 2010, Chinese economic activity slowed down to 6.1% in 2019, its lowest rate since 1990. This was mainly due to a lesser contribution of investment to growth, reflecting a loss of steam in the growth model.

- In China, GDP per capita has increased nine-fold over the past quarter century owing to the significant economic advances made over the period. This has enabled 745 million people to exit poverty. But, the Chinese growth model, which is widely funded through corporate and local government debt, has generated severe internal imbalances: (i) excessive indebtedness for all its economic agents (businesses, public sector and financial sector); (ii) an unstable real estate market which experiences frequent bubbles; (iii) a vulnerable banking system. This is compounded by excess production capacity which now puts a drag on growth. To safeguard external balances, the authorities have combined controls of capital outflows with foreign exchange controls, aiming at mitigating capital flight and currency volatility.

- Since 2016, the Chinese authorities have been conducting a series of reforms to limit the risks of a disorderly correction of imbalances and to redirect the growth model towards final domestic consumption and the tertiary sector. For the time being, the rebalancing process, which takes time to gain traction, is causing a gradual slowdown in growth.

- By expanding its services production and giving momentum to domestic consumption, China's trade integration has fallen; exports as a share of GDP are down and so is processing trade. To diversify its financing sources, China has bolstered its international financial integration which, in the long run, will make the global economy more exposed to Chinese domestic risks.

Contribution to GDP growth



Source: NBS (National Bureau of Statistics).

1. China has major domestic financial imbalances[1]

Over the last two decades up until the coronavirus crisis, China underwent significant economic transformations, grounded in investment and integration in global value chains, which enabled it to become a major player on the world economic stage. After very strong real growth averaging 10% per year between 1980 and 2010, Chinese economic activity slipped back to 6.1% in 2019, its lowest rate since 1990. This was mainly due to a lesser contribution of investment to growth which attests to the fact that the model is losing steam. More recently, measures to clean up the financial sector and deleverage the economy, combined with the scaling up of the trade war with the United States, have had a negative effect on lending and exports, which have historically driven growth, without allowing private consumption to take up the slack. As there are a lack of social safety nets, this consumption is being held back by the broad trend for savings. This augurs for a more substantial slowdown in Chinese growth in the medium term. The authorities have to decide between rebooting economic activity at the cost of heightened financial imbalances, which would endanger medium-term potential growth, and continuing with the deleveraging and clean-up of the financial sector that are required to narrow internal imbalances and pave the way for sustainable medium-term growth.

1.1 Debt, which is the engine of Chinese economic development, has become excessive

Since the era of economic reforms and liberalisation started by Deng Xiaoping in 1978, China has witnessed a number of stages of development sustained, besides other reforms, by financial policies (monetary, credit and prudential) introduced by the authorities[2] and which have led to a sharp increase in bank lending.

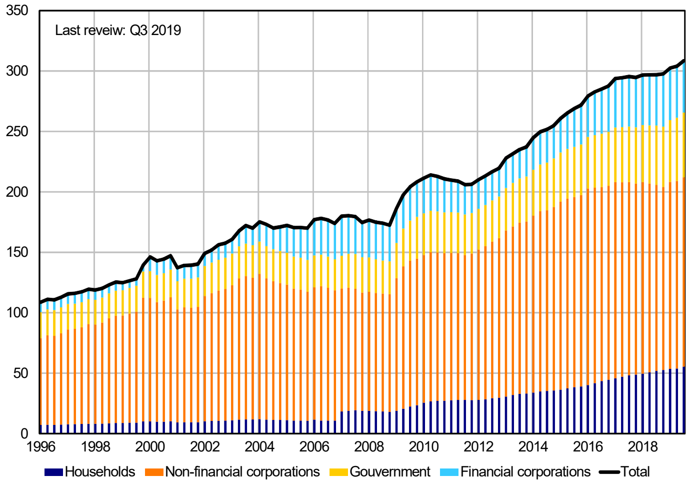
This debt momentum sped up in the aftermath of the 2008 financial crisis under the impetus of a huge economic stimulus plan (USD 586bn over two years, i.e. almost 13% of GDP) aimed at infrastructure and essentially funded by borrowing, in particular through Local Government Financing Vehicles (LGFVs). This off-balance sheet debt was facilitated by the central bank's accommodative monetary policy (lowering of interest rates and the reserve requirement ratio (RRR), elimination of quotas on bank loans). Whilst the stimulus plan provided support for economic activity (in 2009 approximately 8% of the 9.4% growth recorded is thought to have been attributable to it)[3], it caused a continuous increase in local government (provinces) debt, especially their off-balance sheet debt. The IMF estimates that LGFV debt rose from 13.7% of GDP in 2014 to 34.8% in 2018. This trend was combined with excess capacity in the industrial and property sectors as stimulus-related investment expenditure[4] was focused on them at the expense of more productive sectors. In a context of surplus supply over demand, prices fell in these sectors and this had a negative impact on the profitability and financial situation of businesses with a knock-on effect on the banks with which they had taken out loans.[5]

Measures introduced as from 2013 to contain local government debt had little effect and led to the swift emergence of shadow banking[6] as a means of refinancing loans having reached maturity. Between 2008 and 2016, the share of shadow banking in local governments' non-bank debt rose from 1.5% to 48%.[7]

In 2016, in order to restore confidence in the economic model, the authorities rolled out a set of measures that enabled the debt dynamics of agents to be stabilised in 2017 (See Chart 2), with the downside being a more pronounced slowdown in economic activity in 2018. In 2019, debt again increased due to the new economic support measures introduced in late 2018 which were bolstered in March 2019 in light of the trade war with the United States.

(1) This paper covers a period prior to the start of the COVID-19 pandemic.
(2) Chen K. & T. Zha (2018), "Macroeconomic Effects of China's Financial Policies", (No. w25222), National Bureau of Economic Research.
(3) Chen K., Higgins P., Waggoner D. F. & T. Zha (2016). "Impacts of monetary stimulus on credit allocation and macroeconomy: Evidence from China", (No. w22650), National Bureau of Economic Research.
(4) Chen L., Ding, D. & R. Mano (2018), "China's Capacity Reduction Reform and Its Impact on Producer Prices. International Monetary Fund".
(5) Maliszewski W., Arslanalp M. S., Caparusso J., Garrido J., Guo M. S., Kang J. S., ... & W. Liao (2016), "Resolving China's corporate debt problem", International Monetary Fund.
(6) All non-conventional loans - entrusted loans and trust loans - and bankers' acceptances by the non-bank financial sector. This sector is subject to less stringent regulatory and prudential requirements than the conventional banking sector.
(7) Chen Z., He Z. & C. Liu (2017), "The financing of local government in China: Stimulus loan wanes and shadow banking waxes" (No. w23598), National Bureau of Economic Research.

Chart 1: Level of indebtedness by type of borrower (in % of GDP)



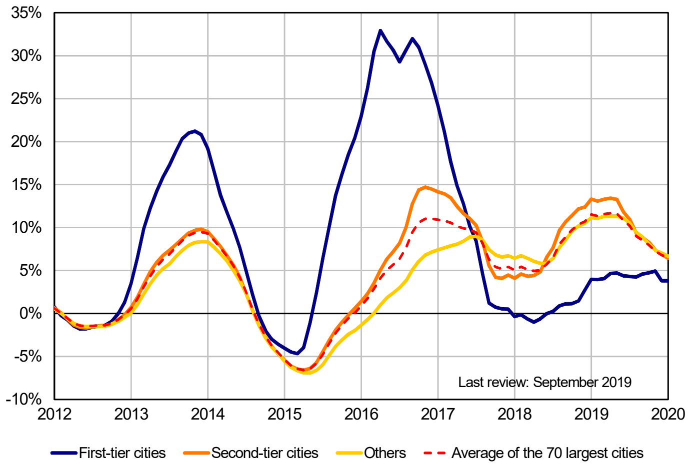
Source: IIF

Although the aggregate debt of economic agents is very high (308.5% of GDP in Q3 2019) compared to other major emerging economies[8], China has headroom that mitigates the danger of a debt crisis in the short term. First, the savings rate is one of the highest in the world (45.7% of GDP in 2018). Second, external debt is still fairly low (14.4% of GDP in 2018) and this eases the exchange rate risk. Lastly, a significant amount of the debt of non-financial corporations (155% of GDP in Q1 2019) is held by public bodies thus making coordination between lenders and borrowers easier[9]in order to avoid default scenarios.

1.2 The property sector epitomises Chinese imbalances

Property investment increased continuously from 2.5% of GDP in 1996 to 17% in 2017, owing to extensive urbanisation, the lack of other investment options for households[10] and conditions concerning taxes and entitlement to *hukou*[11] which foster access to home ownership. In addition, local governments rely on sales of land to fund their infrastructure projects to the extent of 40-45% of their income. This generates conflicting targets between the fiscal requirements of local authorities and their role in regulating the property market. These factors meant that property bubbles began to appear as from 2005. To address this, the authorities introduced restrictive measures to curb property speculation.[12] Since then, the Chinese real estate sector has witnessed repeated investment and stock disposal cycles, reflected by cyclical price changes. Since the end of 2016, further restrictive measures[13] have been put in place to limit crowding-out effects on productive investment and consumption, and to rein in the social risks caused by rising prices (See Chart 2). The authorities elected not to use the property sector as a stimulus mechanism in line with the quote from Xi Jinping that "housing is made for living in, not for speculation".

Chart 2: Changes in property prices (year-on-year)



Sources: CEIC, DG Trésor calculations.

Although the authorities are able to broadly intervene in respect of land, housing and lending, as the property sector is seen as being "too central to fail", reforms will nevertheless be required to mitigate this sector's systemic risks in the long term, such as those relating to the *hukou* system, the banking sector and local public finances. It does however compound sub-optimal allocation of capital and puts a drag on economic growth. According to the World Bank,[14] the fall in productivity in recent years is partly attributable to an expansion of credit to the housing sector, in which returns to capital are deteriorating, at the expense of the productive sectors.

1.3 The banking sector has been undermined by stimulus plans

The Chinese banking sector has low concentration, with the five main commercial banks – which are state-owned and controlled by the Ministry of Finance – only accounting for 40% of the industry's assets. They are highly capitalised, have a comfortable deposit base and essentially finance

(8) For instance, over the same period, Brazil's total debt stood at 200% of GDP whereas the figure was 128% in India.
(9) Song Z. & W. Xiong (2018), "Risks in China's financial system", *Annual Review of Financial Economics*, 10, 261-286.
(10) 87% of households are homeowners with property accounting for 77% of their assets.
(11) The *hukou* registration system differentiates between rural and urban households. Rural households are not entitled to social benefits in towns and cities even if they live and work there (Zhang, 2013).
(12) In particular, suspension of loans following the purchase of a 3rd property, increase in the minimum down payment from 20% to 30% for purchasing the 1st property with the amount being set at 60% for the 2nd property.
(13) Floor for mortgages rates, limitation of financing for property developers on onshore and offshore markets, and restrictions on sales of land.
(14) World Bank (2019), "Innovative China: New Drivers of Growth".

state-owned enterprises (SOEs). The highly varied situations of banks are concealed by the positive indicators on the soundness of the banking sector in 2018.[15] The smallest banks focus on lending to the private sector and their financing resources are more limited as they are not permitted to operate outside their home province and their access to central bank refinancing is more costly, making them more reliant on shadow banking. Up until the tightening of regulations in late 2016, these banks were able to secure low-cost financing on the interbank market despite their lower quality assets because interbank liabilities were seen as being associated with an implicit government guarantee.

As from mid-2017, the authorities rolled out measures to limit shadow banking's momentum by heightening regulation of alternative financial products such as wealth management products and negotiable certificates of deposit (NCDs). This caused financing sources to dry up, especially for joint-stock banks[16] and regional banks, and stepped up competition for receiving deposits which was already stiff due to the new prudential obligations that bolstered requirements as regards adequate equity and provisions for bad and doubtful debts.

This strategy for de-risking the sector had a very negative impact on investment and caused a more serious economic slowdown than anticipated. Private businesses, in particular SMEs that obtained financing primarily from shadow banking,[17] suffered from this tightening of regulations. Private investment growth fell back to 4% (year-on-year) in November 2019, as against an average of 12% between 2016 and 2018. The overrepresentation in the shadow banking clientele of private companies, that are estimated to account for 60% of GDP and 80% of urban jobs according to official data, is due to their narrow access to bank loans. Banks tend to favour state-owned enterprises, which are given implicit government guarantees, have difficulties in assessing the credit risk represented by SMEs and require them to provide substantial guarantees.

As from summer 2018, the authorities unveiled numerous support initiatives for the private sector with an eye to improving monetary policy transmission in the long-term, cutting financing costs and extending the term of loans. In practice, banks, and essentially the major state-owned ones, are instructed to grant more loans to the private sector. As a result, the most fragile amongst them are faced with the dilemma of having to clean up their balance sheets whilst lending more to the most risky counterparties.

The political aim of ensuring GDP growth stability could take precedence over improving capital allocation and cleaning up the sector (See Box 1: The case of Baoshang Bank).

Box 1: The case of Baoshang Bank highlights the problems facing the Chinese banking sector and regulatory inconsistencies

Baoshang Bank was put into receivership in May 2019 and this fuelled doubts as to banking sector soundness. By only guaranteeing part of this failing bank's loans, the People's Bank of China (PBoC) effectively ended the principle of implicit guarantees for interbank lending, thus heightening concerns over the interbank market's liquidity. Major banks are now more reluctant to lend to smaller ones as the security put up by the latter is often comprised of opaque structured, or even toxic, products. The authorities took a number of actions to allay tensions on the interbank market: (i) real-time communication on the conditions for the bank's resolution; (ii) major fund injections of over RMB 600bn via reverse repos; (iii) a call for large banks to lend to smaller ones and to the main brokers so that the latter could help balance the interbank market. The removal of Baoshang Bank's implicit guarantee may have heralded the arrival of a new model which led to greater creditor conservatism. The vulnerability of small and medium-sized banks and their reliance on the interbank market for their supply of funds nevertheless spurred the PBoC to adopt a more accommodative stance. This somewhat skewed the signals sent out to the market and to some extent reintroduced moral hazard on the banking market. As it happens, a number of regional banks have had to be bailed out recently. The authorities were forced to intervene following bank runs on two small banks (Yichuan Bank and Yingkou bank) by reiterating that deposits were "secure", through the deposit insurance fund which was set up in 2015. With an eye to preventing any contagion, the banking regulator is focusing on recapitalising these banks and shoring up the sector.

(15) Non-performing loan rates of 1.8%, solvency ratio at 14.2%, regulatory Tier 1 capital ratio at 11% and return to capital of 11.7%.
(16) Listed privately-owned banks.
(17) Ehlers T., Kong S. & F. Zhu (2018), "Mapping shadow banking in China: structure and dynamics".

1.4 Controls only partly minimise risks

The asymmetric opening of the balance of payments' financial account,[18] with a mixture of measures to control capital outflows and foreign exchange,[19] enables the risks of capital flight and currency volatility to be mitigated.

In 2015, partial financial account liberalisation led to huge capital flight representing some USD 1,500bn, a USD 1,000bn reduction in foreign exchange reserves (out of USD 3,900bn) to stabilise the RMB exchange rate and a 70% fall in the Shanghai Stock Exchange A Share Index.[20] As a result, the authorities reverted to a more progressive and asymmetric opening process. Bayoumi and Ohnsorge (2013) estimate that full financial account liberalisation could lead to gross portfolio outflows of between 15% and 25% of GDP over five years.

Most capital controls involve rules (quotas, reserve requirements, ceilings, strict conditionality) that limit investment outflows, loans and withdrawals of RMB abroad.[21] These controls, that only partly alleviate the risks of massive capital flight, are required to retain domestic savings on which the banks offer low interest rates. The banking system operates by means of "financial repression" whereby margins are boosted by means of an interest rate cap for savings and a floor loan rate (See Chart 3). As they are governed by the rates they apply and are guaranteed to retain household savings, the banks have no incentive to expand their borrower risk assessment capacity. This means that capital allocation is sub-optimal and this is borne out by the increase in the Incremental Capital-Output Ratio (ICOR) which measures the investment needed to cause a given increase in GDP. This ratio has tripled since the financial crisis, rising from three in 2008 to nine in 2018. [22]As they limit foreign competition and the diversification of banks' offerings, capital controls perpetuate this "financial repression" and replace macroeconomic shock absorption mechanisms.

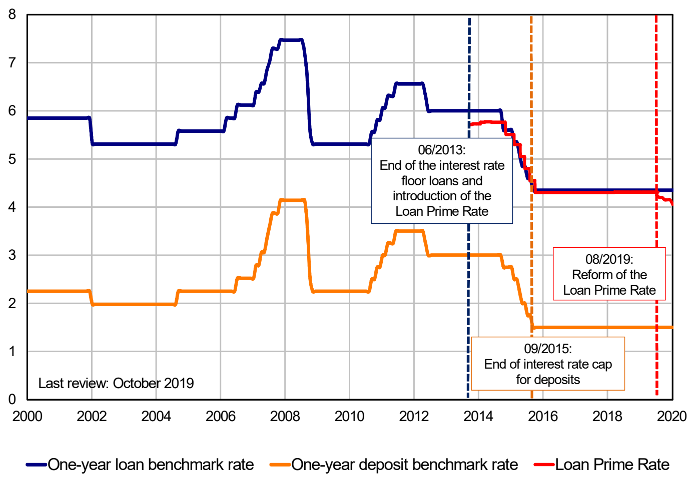
Although exchange rate controls have eased in recent years, they also generate specific risks despite their relative effectiveness in stabilising the RMB exchange rate. They involve altering the definition of RMB parity and interventions by the PBoC on the foreign exchange market. These measures initially resulted in low and one-way RMB volatility (exchange rate set at RMB 8.28 for USD 1 until 2005 followed by a period of almost continuous appreciation through to 2015[23] in the wake of the reform of the RMB exchange rate regime). This meant that the agents became highly sensitive to exchange rate fluctuations, in particular in the case of depreciations, and this had a significant knock-on effect to China's real economy in terms of confidence and investment. This sensitivity is heightened by the opaque nature of the USD/RMB central parity mechanism and difficulties in understanding the PBoC's multiple objectives. Furthermore, these arrangements do not prevent sudden market shocks such as the sharp depreciation of the RMB due to the trade war with the United States in spite of the reintroduction of a counter-cyclical adjustment (CCA) factor[24] in late August 2018. This did not stop the RMB from depreciating by 11% between May 2018 and the end of 2019.

Part of this increase in RMB volatility can be explained by the Chinese authorities' strategy of having their currency's value more determined by market forces. The PBoC has indeed been cutting back on its direct interventions on the foreign exchange market since 2015 and, in its 2019 report, the IMF concluded that the RMB was broadly in line with medium-term fundamentals. Thus the IMF noted that the authorities were not manipulating their exchange rate, despite some controls remaining in place as they were needed, according to the PBoC, to prevent excessive RMB fluctuations.

(18) Within the balance of payments, the financial account records all financial movements between the country and the rest of the world (direct investments; portfolio investments such as shares and bonds; and other types of investments).
(19) Direct intervention on the foreign exchange market or on parity formation.
(20) Aglietta M. and C. Macaire (2019), "Setting the stage for RMB internationalisation", *Policy Brief* CEPII-No 28.
(21) The IMF has published an exhaustive list of capital controls in China (Taxonomy of Capital Flow Management Measures (CFM) 2019).
(22) DG Trésor calculations based on the nominal GDP and fixed capital investment values (capital goods, real estate and construction) published by the Chinese National Bureau of Statistics (NBS).
(23) Between July 2005 and July 2015, the RMB appreciated by 26% compared to the USD and by 58% in real effective terms.
(24) The PBoC introduced this factor in June 2017 following a long period of RMB depreciation. It is seen as the reintroduction of a type of exchange rate control in order to prevent excessive RMB volatility which could be related to speculation.

Whilst financial account and RMB exchange rate liberalisation are still far from complete, they will have to go hand-in-hand to safeguard the independence of monetary policy (See Mundell's Impossible Trinity).[25]

Chart 3: Change in PBoC benchmark interest rates (%)



Source: PBoC.

Box 2: Capital control measures in China

The balance of the Chinese financial account has been positive since 2017 which means that the rest of the world is investing more in China than the opposite. In 2017 and 2018, this investment accounted for 0.9% and 1% of GDP respectively. In 2018, the financial account surplus was higher than that of the current account (0.4% of GDP). Whilst Foreign Direct Investment (FDI) has historically represented the main source of financial surpluses in China (inward FDI stood at USD 203bn in 2018 and the FDI balance at 1.5% of GDP), portfolio investments also posted a positive balance in 2017 and 2018 (0.2% and 0.8% of GDP respectively). Although China applies various types of strict control over these flows of capital, they were generally eased in 2018:

Measures fostering capital outflow (in RMB):

- Increase in quotas limiting foreign investments by Chinese fund managers and businesses in April 2018[a]
- Loosening of controls on Chinese outward FDI after tightening in 2017

Measures fostering foreign capital inflow (in foreign currencies):

- Relaxing of the maximum leverage ratio on external borrowing for enterprises and non-banking institutions
- Easing of restrictions on foreign institutional investors' outflow of funds from China in June 2018[b] and elimination of caps on inward FDI in September 2019[c]

Measures tightening capital outflow (in RMB):

- Control of Overseas Direct Investment (ODI) above USD 300 million by the National Development and Reform Commission (NDRC)
- Reintroduction of reserve requirements on currency transactions in August 2018 to mitigate speculation on the RMB
- Reduction of the overseas RMB withdrawal limits for Chinese individuals[d]
- Tightening of controls over overseas RMB investments by financial institutions in mid-2018 (and stricter conditions for loans by Chinese enterprises to foreign borrowers).

a. Increase in quotas for the following programmes: Qualified Domestic Limited Partnership (QDLP), Qualified Domestic Investment Enterprises (QDIE), Qualified Domestic Institutional Investor (QDII).
b. The three month capital lock-in period and the 20% monthly fund remittance limit have been eliminated.
c. This measure, which relates to the QFII and RQFII programmes, is primarily a symbolic sign of openness as only a third of the USD 300bn in authorised quotas were used
d. RMB 100,000/year since 2016, i.e. around USD 14,000/year and USD 40/day, per person.

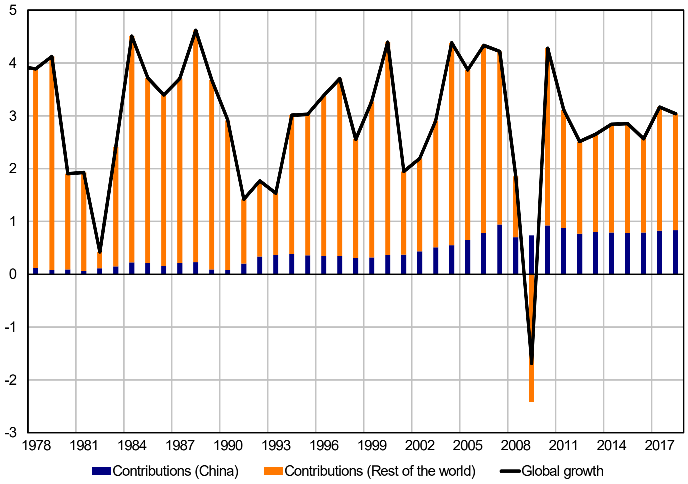
Source: IMF Taxonomy of Capital Flow Management Measures(CFMs) 2019.

(25) A hypothesis under which a country is unable to achieve the following three objectives at the same time: (1) a fixed exchange rate, (2) monetary autonomy and (3) full financial integration with the rest of the world. As China still has exchange controls, it cannot allow the free flow of foreign capital if it wishes to preserve the autonomy of monetary policy.

2. Is the global economy increasingly exposed to China?

Due to China's share of worldwide GDP (13.1% in 2018), global demand (10.8% in 2018), in particular commodities (21.3% in 2017), and its integration in global value chains, a slowdown in its growth would have a direct effect on the world economy through commercial channels and lower commodity prices.

Chart 4: Contributions to global growth (%)



Sources: World Bank, DG Trésor calculations.

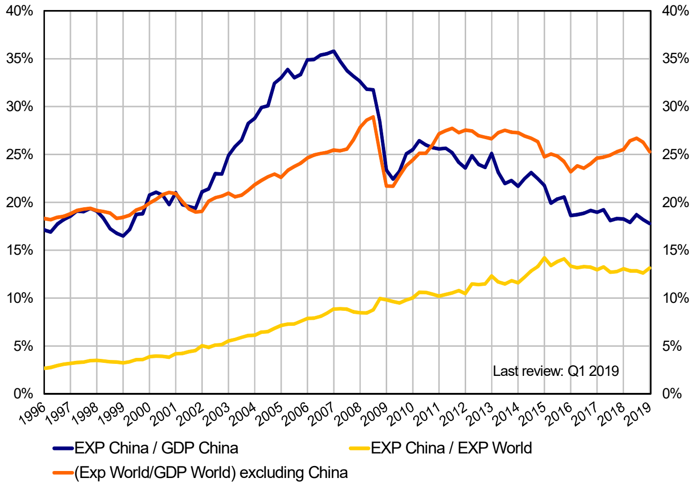
Countries that export commodities and those whose exports are most reliant on Chinese demand would suffer the most. This means that emerging Asian economies and Latin America would be in the firing line.

Nevertheless, the global economy's exposure to China could shift as the Chinese economy evolves towards a smaller role in world trade and increased financial integration.

2.1 Towards a smaller Chinese role in world trade

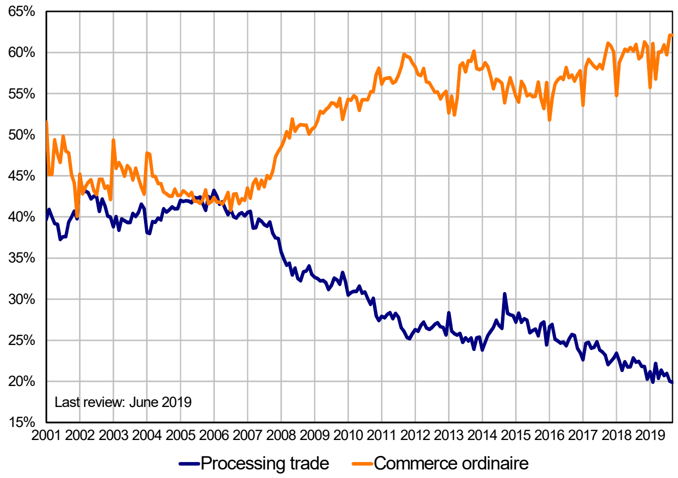
Between 2006 and 2018, exports as a share of Chinese GDP fell from 35% to 18%. Whereas China's involvement in the globalisation of trade and its accession to the WTO contributed to a huge increase of this share between 2001 and 2006, it gradually fell off and took an opposite trajectory to that of the rest of the world (See Chart 5). Besides the reorientation of Chinese activity towards domestic demand, this change is attributable to the increase of Chinese value added in exports at the expense of foreign value added. A major factor for this is reduced Chinese specialisation in processing trade (importing intermediate inputs to transform or assemble them with low value added, before re-exporting them) and the upscaling of its manufacturing. Total Chinese imports of products relating to processing trade fell from almost 40% in 2001 to 22% in 2018 (See Chart 6).

Chart 5: Change in Chinese and global exports



Sources: World Bank, IMF, NBS.

Chart 6: Chinese imports by customs regime (as a % of total imports)



Source: CEIC.

China's changing position in global trade is due to the progressive loss of some competitive advantages such as low labour costs[26] and an undervalued RMB, which was rectified with the continuous exchange rate appreciation between 2005 and 2015. The change is also related to the reorientation of the growth model towards domestic consumption rather than exports and investment.[27]

(26) The minimum wage in Beijing has increased by almost 300% since 2004 and salaries in the manufacturing sectors are now amongst the least competitive in Asia. They were, for instance, around 46% higher than in India in 2018 (JETRO Survey on Business Conditions of Japanese Companies in Asia and Oceania, February 2019).

(27) The average contributions of investment and net exports to real GDP growth fell respectively from 5.2 points and 1 point in 2004-2006 to 2.5 points and –0.2 points in 2016-2018 whilst the contribution of consumption remained stable at approximately 5 points.

China's technological catch-up and the progressive upscaling of its manufacturing industry also reduce its integration to global value chains:

- Its export structure is starting to resemble that of the United States, Europe and Japan. By using a fine level of disaggregation for customs data, the proportion of Chinese exports considered as being similar to products of developed countries rose from 30% in 2000 to 37% in 2017 (Finger-Kreinin index)
- Its exports of low-end products fell from an average of 70% between 2000 and 2005 to 54% in 2017[28] and the share of medium-technology products in total exports rose from 34% to 47% between 2000 and 2012. Conversely, the share of low-technology products dropped from 39% to 28% over the same period.

The continued upscaling of the export industry is a vital strategic issue for China. The ten-year Made in China 2025 plan, which was unveiled in 2015, aims for high-tech industries to procure 70% of their supplies on the domestic market by its end date.

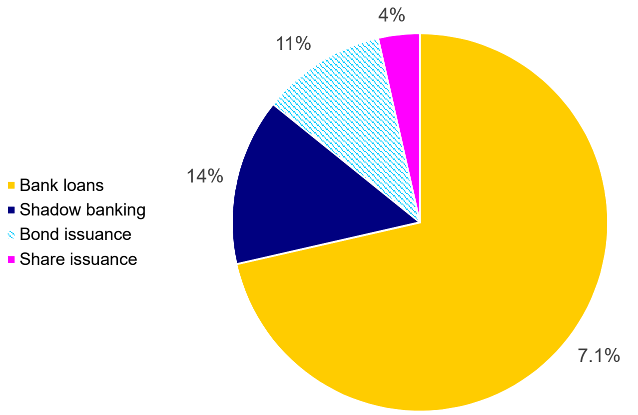
2.2 Low market financing and low financial openness

At a time when its share of world trade has reached a plateau, its trade integration is slackening and the clean-up of the banking sector and domestic deleveraging are becoming priorities, China has been diversifying its sources of financing by bolstering its international financial integration.

At global level, the Chinese banking system is systemic as it finances the Chinese economy (See Chart 7) and because of its size. Since the end of 2016, it has had more total assets than the euro area banking system. Bank loans account for 72% of financing for the Chinese economy compared to only 11% for bond debt (more than half of which is issued by the public sector)[29] and 4% for shares.

Market financing is still primarily domestic with foreign investors only holding 2.4% of the Chinese equity market and 1.6% of its bond market in 2017.[30] In addition, the Chinese investor base is narrow as commercial banks hold 65% of central government bonds and 86% of local government ones.[31] The buy and hold strategy adopted by Chinese banks also means that the bond market suffers from a lack of liquidity, is erratic and therefore risky. Moreover, the equity and bond markets are fragmented (multiple regulators) and unreliable (frequent suspensions in equity trading). The low level of external debt (14.8% of GDP in 2018) is also attributable to scarce use of international markets.

Chart 7: Sources of financing of the economy in 2018



Source: NBS.

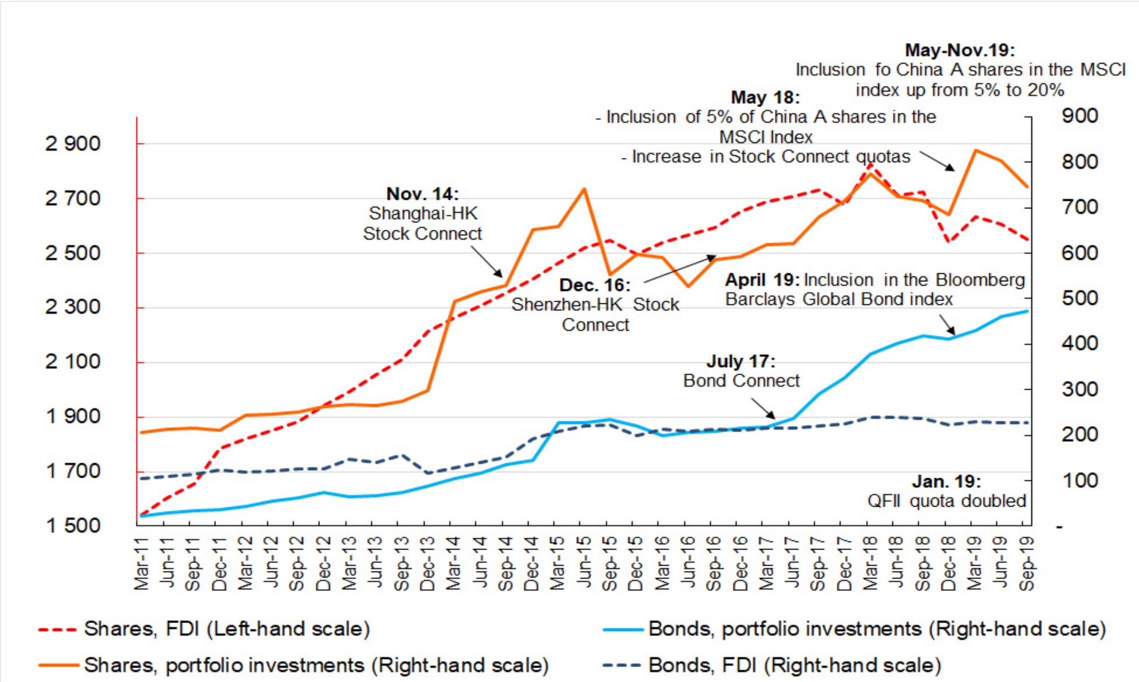
2.3 Progressive opening of the financial account

Financial flows between China and the rest of the world are on the rise although their levels remain moderate.[32] These flows began to circulate in 2010 and have been stepped up since 2013 when the RMB became able to be freely used for global trade[33] without being fully convertible due to capital controls. The majority of these flows pass through the Hong Kong financial centre.[34] Demand for RMB investment products has risen, as a reflection of the Chinese currency's growing international role,[35] the rise in the proportion of Chinese foreign trade invoiced in RMB (up from 2.5% in 2010 to 16.9% in 2016) and the Belt and Road Initiative (BRI).[36]

(28) As a comparison, this proportion was 22% in Germany and 36% in Romania in 2017.
(29) The Chinese bond market, which is mainly comprised of government debt (60% of the total), policy bank bonds and PBoC bills, grew rapidly from 1% of global bonds in early 2000 to 9% at the end of 2017, i.e. almost USD 10,000bn.
(30) Cerutti and Obstfeld (2018, *IMF Working Paper*).
(31) Aglietta, M., Macaire, C. (2019), "Setting the stage for RMB internationalisation", *Policy Brief* CEPII-No 28.
(32) In 2017, foreign capital inflows only accounted for 3.6% of GDP, i.e. almost six times less than export flows (20% of GDP). Nevertheless, the balance of the Chinese financial account has been positive since 2017 which means that the rest of the world is investing more in China than the opposite. In 2017 and 2018, this investment accounted for 0.9% and 1% of GDP respectively. In 2018, the financial account surplus was higher than that of the current account (0.4% of GDP).
(33) As witnessed by the RMB being included in the IMF's SDR currency basket on 1 October 2016.
(34) Between 2010 and 2018, Hong Kong was behind 73% of mainland China's stock exchange listings, 60% of its bond issuance and 64% of inward FDI. Source: Natixis.
(35) In July 2019, the RMB was the fifth most used currency in the world, up from 20th place in January 2012.

For the time being, international investors still favour low-risk assets such as major bank and central government bonds. The IMF estimates that, over the last five years, the number of Chinese sovereign bonds held by non-residents has increased four-fold, to almost 8% of the total outstanding amount. The inclusion of Chinese government and policy bank bonds in the Bloomberg Barclays Global Aggregate Index in April 2019[37] should also boost demand from international investors for Chinese securities. The inclusion of China A-shares (equities listed on the onshore market[38] and traded in RMB) in the MSCI Emerging Markets Index as from 2018[39] and the planned inclusion of Chinese shares in the JP Morgan and FTSE indexes could also result in substantial foreign capital inflows. It is estimated that portfolio investment inflows tripled between 2016 and 2018 to stand at USD 159bn[40] and inclusion in international indexes could bring in as much as an extra USD 150bn in 2020[41] (i.e. almost half of 2018 bond issuance). Lastly, the Stock Connect gateway between the Hong Kong and Shanghai stock exchanges, which was set up in late 2014 and which allows for transactions between international investors (from Hong Kong) and mainland China (from Shanghai), has been instrumental in the increased demand for securities issued in mainland China.

Chart 8: Capital inflows into China, in USD bn



Sources: SAFE, IMF BPM6.

The appeal of investments in RMB for foreign investors also carries strategic interest for China from both a domestic and international standpoint.

Domestically, the asymmetric easing of capital controls to foster foreign capital inflows could facilitate national reforms, especially of the financial system (See 1.3 above) and interest rate liberalisation.[42] Broader exposure to foreign competition could improve the allocation of savings, upgrade the banking and insurance system's offering, whilst providing an additional source of financing for the Chinese economy at a time when access to conventional sources (banks, shadow banking) is more difficult due to the clean-up and deleveraging policies.

Internationally, opening up to foreign capital is bolstering the RMB's status as an international currency and store of value. It is enabling China to mitigate its exchange rate risks

(36) See Dumond J., Landais M. and P.Offret (2018), "The New Silk Road", *Trésor-Economics* no. 229.
(37) In the long term, 6% of the index will be comprised of Chinese shares. Index representing over USD 2,000bn in assets.
(38) The onshore market refers to the Chinese domestic market which is controlled and partially closed to foreign investors, unlike the offshore markets (Hong Kong, Singapore).
(39) Although MSCI is remaining cautious about further inclusions of Chinese shares, there is major scope for progress as the China A shares included in the index since 26 November 2019 only account for 20% of total capitalisation of the Chinese share market.
(40) IMFBlog, China Deepens Global Finance Links as It Joins Benchmark Indexes, June 2019, Sally Chen, Dimitris Drakopoulos, Rohit Goel.
(41) IMF Global Financial Stability Report, Vulnerabilities in a Maturing Credit Cycle, April 2019.
(42) Since 2013 and in line with the loan prime rate reform in August 2019, the Chinese authorities are looking to gradually liberalise interest rates so as to better reflect the market. Nevertheless, banks still only rarely deviate from the central bank's benchmark rates.

when its investments are in RMB. Against the backdrop of the 2017 US tax reform (encouraging firms to massively repatriate their foreign subsidiaries' earnings) and Sino-US tension, which is fuelled, inter alia, by suspicions of forced technology transfers in foreign subsidiaries based in China, inward foreign FDI to mainland China stalled in 2019 compared to the previous year (+0%) and inward FDI to Hong Kong declined by 48%.[43] Attracting global, and particularly European, FDI has therefore become more strategic for China which is striving to stabilise its inward FDI in a difficult context. Lastly, the downward trend for the Chinese current account surplus could require an inflow of foreign capital to finance the balance of payments deficit. As a matter of fact, China's new Foreign Investment Law, which came into effect in January 2020, aims to ensure that foreign firms are treated in the same way as Chinese state-owned enterprises. However, the business world is hedging its betsregarding the law's actual implementation.

Foreign investors should nevertheless adopt a conservative approach before increasing their exposure to Chinese risks as the Chinese economy is beset with great fragility owing, first and foremost, to its over-indebtedness (See Part 1). Despite measures introduced since July 2017 to improve sovereign credit rating[44] and bolster financial supervision and coordination between regulators (setting up a Financial Stability and Development Committee), caution should remain the rule in view of the financial difficulties being faced by a number of banks and firms (such as clothing giant Shandong Ruyi, Yuhuang Chemical and the commodity trader Tewoo Group) in repaying their foreign-currency debts. In addition, financial supervision alone will not be enough to improve the solvency of local governments, which represent the main public debt issuers, since their budget balance will only be restored by sweeping fiscal reform to place more of the social expenditure burden on central government.

Lastly, the opening of the financial account, in particular to outflows, would give the world access to the substantial financial windfall represented by Chinese domestic savings.[45]In light of the trend observed, these investment flows would be especially earmarked for sectors in which China has no comparative advantage, such as the high-tech industries of developed countries, on the basis of financial and industrial strategies focusing on asset diversification and technology acquisition.[46]

Célia Colin, Colette Debever et Hannah Fatton

(43) According to UNCTAD's Global Investment Trend Monitor, published on 20 January 2020.
(44) In January 2018, S&P Global Ratings was granted a licence to rate Chinese domestic bonds following suspicions of corruption at the national ratings agency.
(45) Around USD 6,218bn in 2018.
(46) Agarwal Gu & Prasad (2019), "China's Impact on Global Financial Markets", *National Bureau of Economic Research*.

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Publication manager:
Bertrand Dumont

Editor in chief:
Jean-Luc Schneider
(01 44 87 18 51)
tresor-eco@dgtresor.gouv.fr

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