SECTION 2: VULNERABILITIES IN CHINA’S FINANCIAL SYSTEM AND RISKS FOR THE UNITED STATES

Key Findings

• China’s formal financial system is dominated by state-owned banks, whose position has been strengthened in the wake of the novel coronavirus (COVID-19) pandemic in 2020. These banks favor state-owned enterprises (SOEs) and privileged companies, leaving other Chinese companies starved for capital. Between 2008 and 2016, a large and unwieldy shadow banking sector emerged to fill this gap, leading to a proliferation of risky financial products and rising leverage across China’s financial sector.

• In 2016, Beijing launched a financial de-risking campaign to rein in shadow banking activity and clean up the financial sector. This campaign choked off small private companies’ access to financing. The COVID-19 pandemic has further deteriorated the financial health of these companies, forcing the government to ease its regulatory tightening and prioritize economic stability over financial de-risking. With such vulnerabilities remaining unaddressed, investors in China’s capital markets are increasingly exposed to structural problems in China’s financial system.

• As Beijing strategically opens its financial sector to secure foreign capital and global investment indices shift asset allocations toward Chinese securities, U.S. investors’ exposure to the unique and significant risks accumulated in China’s capital markets rises. These risks center around the opacity of China’s financial system and Beijing’s interference in market activity to advance its political objectives.

• Increased financial exposure to China threatens to undermine U.S. efforts to defend against China’s unfair economic practices and protect U.S. policy interests. Several Chinese companies included in global investment indices are subject to U.S. export controls but not investment restrictions. This mismatch enables problematic Chinese companies to continue raising U.S. capital and reduces the strength with which the United States can defend against companies that threaten national security.

• While China’s leadership speaks of developing more dynamic capital markets, liberalizing interest rates, and imposing market discipline on the banking sector, these ambitions are tempered by a low tolerance for market instability and a strong bias in favor of state-owned companies to maintain economic growth and safeguard employment.
After years of unbridled lending, China’s financial system is facing mounting problems. Local governments have recorded significant revenue shortfalls, banks remain undercapitalized, and an aging population threatens persistent current account deficits. The Chinese government seeks to attract large volumes of new foreign investment to meet these capital shortfalls. These circumstances provide the key context for the entry of foreign capital and expertise into the country’s financial system.

Beijing continues to deny U.S. audit regulators full visibility into the financials of U.S.-listed Chinese companies in line with U.S. accounting standards. These evasions from effective regulation and oversight, together with U.S.-listed Chinese companies’ complex ownership structures, deprive U.S. investors of both full transparency and the opportunity for legal redress in cases of accounting fraud, eroding the integrity of U.S. capital markets.

The COVID-19 pandemic has exacerbated key risks in China’s already strained financial system. Although a full accounting of economic damage is still underway, China’s first economic contraction in four decades will make it more difficult to tackle the country’s debt burden, resolve nonperforming loans (NPLs), and efficiently allocate capital.

Beijing’s imposition of the national security law in Hong Kong has accelerated the territory’s assimilation into China’s national governance system, which could erode its status as a global financial hub. As the Chinese government calibrates financial opening, it may lean more on Hong Kong to raise foreign capital and serve Chinese companies and continue to rely on the territory as an extension of mainland capital markets.

**Recommendations**

The Commission recommends:

- Congress enact legislation establishing a China Economic Data Coordination Center (CEDCC) at the Bureau of Economic Analysis at the U.S. Department of Commerce. The Center would be mandated to collect and synthesize official and unofficial Chinese economic data on developments in China’s financial markets and U.S. exposure to risks and vulnerabilities in China’s financial system, including:
  - Data on baseline economic statistics (e.g., gross domestic product [GDP]) and other indicators of economic health;
  - Data on national and local government debt;
  - Data on nonperforming loan amounts;
  - Data on the composition of shadow banking assets;
  - Data on the composition of China’s foreign exchange reserves; and
  - Data on bank loan interest rates.

- Congress request that the Administration prepare a report on the research and development activities of the affiliates of U.S. multinational enterprises operating in China and the implica-
tions of such activities for U.S. production, employment, and the economy.

Introduction

The Chinese government’s urgent drive to raise and deploy new capital is precipitated by the many challenges its economy faces after a decade of unprecedented credit expansion following the 2008 financial crisis. According to the Bank for International Settlements, China’s total debt ballooned from $6.5 trillion at the end of 2008 to $36.8 trillion at the end of 2019, equivalent to 258.7 percent of GDP. By the second quarter of 2020, the World Bank reported China’s debt-to-GDP ratio rose to an even higher 283 percent. Much of this debt was created by bank lending, with many bank loans backed by opaque, high-risk assets. The rapid accumulation of this risky debt outpaced China’s economic output, which expanded only $9.7 trillion from 2008 to 2019, leading to a slew of unproductive investment and waste in the financial system. Even before the COVID-19 outbreak strained banks’ balance sheets, Beijing was already grappling with how to manage the fallout of this excess and the subsequent capital stresses on the financial system. These include an enormous debt burden, an undercapitalized banking system, high levels of nonperforming assets, and a drawdown on national savings as China’s population ages.

Recent moves to open China’s financial market reflect a calculated strategy by the Chinese government to draw in foreign capital to address some of these challenges. This managed financial opening is in turn exposing U.S. and other foreign investors to heightened risks and systemic vulnerabilities unique to China, where the government’s opaque political structure and intrusive regulatory state erode market independence. Of particular concern is the rising inclusion of Chinese securities in global investment indices. These securities range from equity shares issued by companies whose operations threaten U.S. national security to sovereign bonds that may fund SOE bailouts. The passive investment management style of investment indices, whose composition and operation are lightly regulated in the United States, may lead U.S. investors to indirectly finance Beijing’s industrial planning priorities or otherwise assume investment risks they cannot fully assess or price.

This section evaluates the challenges China’s financial system faces in creating and allocating capital as China’s economic growth slows. It also explores the risks associated with investing in Chinese securities as their inclusion in global investment indices grows. Finally, the section reviews U.S. regulatory capabilities to manage risks to U.S. investors and policy interests from rising exposure to China’s capital markets. The section is based on the Commission’s January 2020 hearing on “China’s Quest for Capital: Motivations, Methods, and Implications,” briefings and consultations with experts and U.S. officials, and open source research and analysis.

* By comparison, the United States’ total debt reached $54 trillion in the fourth quarter of 2019, equivalent to 253.7 percent of GDP. Bank for International Settlements, “Credit to the Non-Financial Sector,” September 14, 2020.

† These figures are reported as nominal values, and unless otherwise noted this section uses nominal values throughout.
Structural Overview of China’s Financial System

China’s distorted financial system is defined by centralized control and pervasive interference by the government and Chinese Communist Party (CCP). Large state-owned banks own more than half of total banking sector assets and channel low-cost funds to firms privileged by the state. China’s capital markets more readily serve large and often state-supported firms. Onerous listing requirements prevent smaller firms from raising capital in China’s stock markets and bond markets remain state-dominated and rife with already heavily indebted issuers.

Though the government is taking steps to address some of these inefficiencies in China’s financial system, it continues to prioritize industrial planning and stability at the cost of accountability to investors and market independence. This excessively interventionist management of the economy injects distortions into China’s financial system. These distortions have come into stark relief as regulators embark on a cleanup of the banking sector and unearth systemic problems caused by a decade of quickly accumulated debt. Policymakers are now struggling to manage public expectations that the government will always be there to bail out struggling banks or companies. Limited access to financing for small- and medium-sized enterprises (SMEs), as well as a drawdown of national savings as China’s population ages, place further strain on China’s financial system.

Estimating the Unknown in China’s Financial System

The reliability of the Chinese government’s official financial data, including the true extent of NPLs, shadow banking assets, government debt, and composition of foreign exchange reserves, has long been in question. The CCP falsifies or obscures the official economic statistics it reports or withholds information entirely to control public impressions of its management of the economy. In addition, data on other components of China’s financial system, such as interest rates charged on loans to SOEs versus SMEs, is fragmentary, requiring consultation of disparate official and unofficial sources to arrive at estimates sufficiently credible to inform meaningful analysis. This section accordingly supplements official figures reported by the Chinese government with data independently collected by other analysts, where available, to enable the fullest possible assessment of China’s financial system and its allocation of capital to different actors in China’s economy.

Banks Dominate, Capital Markets Languish

Banks play an outsized role in China’s financial system, and the Chinese government exerts pervasive influence across the full spectrum of China’s banking sector. This is most visible through the

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†China’s banking sector comprises more than 4,000 commercial banks, though the six largest state-owned banks (Industrial and Commercial Bank of China, China Construction Bank, Bank of China, Agricultural Bank of China, Postal Savings Bank of China, and the Bank of Commu-
“Big Six” state-owned banks, which together hold 40.3 percent of banking assets.* Local governments also shape the lending practices deployed by subnational banks at the provincial and lower levels. This preponderance of the state in China’s banking system instills a lending bias toward SOEs. Though China’s SMEs can still borrow from the banks, they do so at a higher cost: some analysts estimate the average interest rate on loans to private firms is 3 percentage points higher than that for SOEs. Large banks with national operating licenses hold the bulk of commercial bank assets (see Figure 1).\(^7\)

*Banking assets are resources formed by transactions conducted by commercial banks, including loans, investments (securities investment, cash assets investment, fixed assets investment), leasing, and foreign exchange trading, among others. Chinese banks have also historically derived significant funding from household deposits, though a steady decline in household savings rates since 2010 has placed further stress on bank balance sheets. Zhiguo He, written testimony for U.S.-China Economic and Security Review Commission, Hearing on China’s Quest for Capital: Motivations, Methods, and Implications, January 23, 2020, 6; Guofeng Sun, “Banking Institutions and Banking Regulations,” (draft) in Marlene Amstad, Guofeng Sun, and Wei Xiong, eds., The Handbook of China’s Financial System, forthcoming Princeton University Press, 2020, 5; Longmei Zhang et al., “China’s High Savings: Drivers, Prospects, and Policies,” International Monetary Fund, December 11, 2018, 10–11.
Since state firms already have easy access to financing, companies raise comparatively little money in China’s stock market. In 2019, China’s stock market accounted for only 2.9 percent of aggregate financing.\(^8\) The development of China’s stock market is hindered by stringent listing requirements* with which politically connected state firms can more easily comply.\(^9\) China’s government, as opposed to the market, also continues to influence the decisions of all issuers in China’s stock market, regardless of their ownership. The September 2018 listing guidelines issued by the China Securities Regulatory Commission (CSRC), for example, require all publicly traded Chinese firms to set up CCP cells within their leadership structures.\(^\dagger\)\(^10\)

**China’s Evolving Bond Markets Serve the State First**

Bonds are an important source of direct financing for state-affiliated companies and an economic stimulus tool for Beijing. Developments in 2020 suggest the Chinese government is prioritizing the attraction of foreign capital into China’s state-dominated‡ bond markets ahead of other policy changes that would strengthen private enterprises’ ability to participate in them. For example, in July 2020 China’s financial authorities announced the interbank and exchange-traded bond markets would be unified§ to “further facilitate

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\(^8\) China’s stock market has historically featured high thresholds on earnings and cash flow requirements for companies seeking to list. For example, prior to stock market reforms undertaken in 2020, a company needed to demonstrate in its initial public offering (IPO) application to the CSRC that it had generated positive earnings in the past three consecutive years with accumulated earnings in excess of renminbi (RMB) 30 million. These tight requirements explain why some Chinese companies, particularly in the startup and technology sectors, choose to list in overseas markets such as the United States. According to one study, if JD.com tried to list in China rather than on Nasdaq in May 2014, it would have had to show profits in 2011, 2012, and 2013, and a small loss that occurred in 2012 would have made it impossible to list in China. Franklin Allen et al., “The Development of the Chinese Stock Market,” (draft) in Marlene Amstad, Guofeng Sun, and Wei Xiong, eds., *The Handbook of China’s Financial System*, forthcoming Princeton University Press, 2020, 18.

\(^9\) While it has long been presumed that all Chinese companies feature CCP organizations in their leadership structures, the updated listing guidelines issued in 2018 appear to be the first codification of such a requirement with respect to publicly listed companies. Specifically, Article 5 of the guidelines states that “organizations of the Communist Party of China should be established in a listed company in accordance with the Company Law.” The Company Law (last updated in 2013) was ambiguous on this point and did not indicate that listed companies specifically should feature such organizations, instead stipulating in its Article 19 that “in a company, an organization of the Communist Party of China shall be established to carry out the activities of the Party in accordance with the charter of the Communist Party of China.” The Company Law’s Section 5 on “Special Provisions on the Organizational Structure of Listed Companies” makes no reference to requirements for CCP cells. China Securities Regulatory Commission, *Announcement No. 29 “Government Standards for Listed Companies”* (第29号公告《上市公司治理准则》), September 30, 2018. Translation. http://www.csrc.gov.cn/pub/zhjpublic/zjh/201809/t20180930_344906.htm; China Securities Regulatory Commission, *Company Law of the People’s Republic of China (Chairman’s Order No. 8, as Amended on December 28, 2013)* (中华人民共和国公司法(主席令第8号, 2013年12月28日修正)), December 28, 2013. Translation. http://www.csrc.gov.cn/pub/shenzhen/xxfw/tzzsyd/ssgs/zh/zhxx/201409/t20140918_260530.htm.

\(^\dagger\) Most bonds traded in China’s fixed-income markets are issued by state-affiliated entities, such as state-owned banks, local government financing vehicles (LGFVs), and SOEs. LGFVs are economic entities established by China’s local governments to finance government invested projects, typically infrastructure and real estate development projects. Because local governments are barred from borrowing directly from banks, they use LGFVs to borrow money to finance projects. Marlene Amstad and Zhiguo He, “China’s Bond and Interbank Market,” (draft) in Marlene Amstad, Guofeng Sun, and Wei Xiong, eds., *The Handbook of China’s Financial System*, forthcoming Princeton University Press, 2020, 6; Kate Jacquet, “The Evolution of China’s Bond Market,” *Seafarer Funds*, March 2019, 12.

\(^\S\) Most bonds in China were previously traded in two distinct markets: the over-the-counter interbank market and the Shanghai and Shenzhen stock exchanges. The interbank market is the more consequential of the two, with about 89 percent of total bonds outstanding traded on it in 2018. Marlene Amstad and Zhiguo He, “China’s Bond and Interbank Market,” (draft) in Marlene Amstad, Guofeng Sun, and Wei Xiong, eds., *The Handbook of China’s Financial System*, forthcoming Princeton University Press, 2020, 3.
bond investors” and ease trading, clearance, and settlement procedures. The measures reduce the complexity of trading procedures for China’s bond market, further attracting foreign investors.

Chinese bond issuance has grown rapidly in recent years and the onshore bond market more than doubled in size from $6.4 trillion (renminbi [RMB] 45.4 trillion) at the end of 2015 to $13.3 trillion (RMB 94.2 trillion) in June 2020.* Despite this growth, China’s bond market remains relatively illiquid. For example, in 2018 Chinese treasury bonds and policy bank bonds had turnover ratios † of 1.3 percent and 3.6 percent, respectively, compared to 10 percent for U.S. treasuries the same year. Local government bonds, and particularly special purpose bonds that are backed by a specific project or group of projects, have also become an increasingly important fiscal stimulus tool over the last several years. Since 2017, the State Council has continually increased the annual quota for special purpose bonds and resorted to frontloading issuances from the 2019 and 2020 quotas to prop up economic growth. By the first week of July 2020, the entire $529.7 billion (RMB 3.75 trillion) special purpose bond quota—a $226 billion (RMB 1.6 trillion) increase over the previous year’s quota—had already been allocated.

China’s Credit Ratings Ecosystem Obscures Debt Risks for Investors

While China possesses a full credit ratings ecosystem, systematic ratings inflation by Chinese ratings agencies compromises the integrity of credit rating in China, obfuscates debt risk, and may ultimately harm overseas investors exposed to China’s fixed income markets. Ratings inflation by Chinese ratings agencies is visible in a clustering of scores at the top of the ratings spectrum. At the end of 2018, 96 percent of nonfinancial bonds carried a rating of AA or above.‡ Moreover, according to one study’s sample of investment-grade bonds, foreign credit ratings agencies on average rate bonds by the same Chinese issuer a staggering six to seven grades lower than mainland Chinese ratings agencies. The inflation of credit ratings partially stems from the disproportionate representation of state-owned companies in the bond market. For example, in 2019, private companies accounted for only 7.7 percent of total corporate bond issuance. The high concentration of SOEs in the bond market inflates the ratings distribution because investors assume state-sector borrowers enjoy government support and therefore present a lower credit risk. At the same time, China Banking and Insurance Regulatory Commission (CBIRC) rules also require banks and insurance companies to invest only in bonds rated AA or higher. Combined with

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*Unless noted otherwise, this section uses the following exchange rate throughout: $1 = RMB 7.08.
†A bond’s turnover ratio measures its liquidity by dividing the total number of bonds traded over a period by the number of bonds outstanding in the same period. It indicates the frequency at which outstanding issues have been traded in the market. Bank for International Settlements, “Fixed Income Market Liquidity,” January 2016, 9.
‡Credit ratings help investors differentiate between bonds with higher credit risks (those assigned a lower credit rating) and lower credit risk (those assigned a higher credit rating). Investment-grade bonds with the safest credit rating are rated as AAA, while those with the lowest credit rating are rated as BBB or BAA, depending on which global rating agency’s scale is being used. Nina Boyarchenko and Or Shachar, “What’s in A(AA) Credit Rating?” Liberty Street Economics, January 8, 2020.
China’s Credit Ratings Ecosystem Obscures Debt Risks for Investors—Continued

the fact that banks are dominant participants in China’s bond market, holding 56.2 percent of corporate bonds and 86.1 percent of local government bonds at the end of 2019, this makes AA the de facto lowest investable bond grade (the international equivalent would be a BBB rating).23

The entry of foreign ratings agencies into China’s bond market, which began with the entry of S&P into China’s ratings market in the first half of 2019, potentially represents an opportunity for Beijing to overhaul the ratings ecosystem and encourage foreign investment in the bond market.24 This opportunity is contingent, however, upon the Chinese government allowing foreign ratings agencies access to financial statements and information in order to issue objective assessments of Chinese entities’ creditworthiness. Foreign ratings agencies may also feel pressure to provide higher ratings in order to gain market share as Chinese companies seek the highest rating possible.25 In testimony before the Commission, David Loevinger, managing director at asset management firm TCW, said it remains “an open question” whether foreign ratings agencies will be able to issue objective ratings and “call it like they see it” in China’s financial markets.26 Even if foreign ratings agencies are permitted to apply fair and impartial standards, they must contend with potential accounting irregularities that are not always detected or disclosed by auditors.

Shadow Banking Crackdown Eases

Outside of formal banking channels, China’s financial institutions perform a variety of credit intermediation functions known as shadow banking.* In the decade following the global financial crisis, shadow banking grew rapidly and new instruments for risky lending proliferated. Concerned about the stability of the financial system, regulators launched a campaign to rein in shadow banking activities in late 2016 as part of a broader financial cleanup. These regulatory efforts succeeded in reversing the growth of shadow banking. Although shadow banking activity is, by design, difficult to measure, Moody’s estimates that total shadow assets contracted from $9.1 trillion (RMB 64.5 trillion) at the end of 2016 to $8.3 trillion (RMB 59 trillion) at the end of 2019.27

Shadow banking serves as an especially important channel of credit provision to small private companies whose ability to access financing was disproportionately squeezed by the regulatory tightening, weighing on economic growth. Therefore, amid slowing economic

*Shadow banking is lending that occurs outside the formal banking sector and is therefore not subject to the same prudential regulations as bank lending. Examples of shadow banking components include trust loans, entrusted loans, peer-to-peer lending, wealth management products, certain kinds of asset management plans, and structured deposits. For more background on China’s shadow banking sector, see U.S.-China Economic and Security Review Commission, Chapter 1, Section 1, “Year in Review: Economics and Trade,” in 2017 Annual Report to Congress, November 2017, 49–50; U.S.-China Economic and Security Review Commission, Chapter 1, Section 3, “Governance and Accountability in China’s Financial System,” in 2013 Annual Report to Congress, November 2013, 113–152.
growth in 2019 and the COVID-19 pandemic in 2020, regulators eased pressure on shadow banking and allowed certain subcategories of shadow banking activity to make a modest recovery. This easing is visible in the slowing pace of shadow banking contraction (see Figure 2) as well as in a significant uptick in nonbank financing captured by survey data from China Beige Book.

Figure 2: China's Total Shadow Banking Assets, Q2 2018–Q2 2020

<table>
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<tr>
<th>Quarter</th>
<th>RMB trillions</th>
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<td>Q2 18</td>
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<td>Q3 18</td>
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<td>Q4 18</td>
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<td>Q2 20</td>
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Note: The U.S. dollar value of shadow banking assets in the second quarter of 2020 was $8.8 trillion.
Source: Various.

Despite this easing, China's shadow banking sector potentially faces significant disruption as China's already slowing economy is further undercut by the COVID-19 outbreak. For example, over the course of 2019, the value of outstanding trust assets* with disclosed repayment risks† increased 159.7 percent from $31.4 billion (RMB 222.2 billion) at the end of 2018 to $81.5 billion (RMB 577 billion) a year later. This number is expected to continue rising as another-

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*In contrast to trust companies in the United States whose primary business is to act as a fiduciary in the administration of assets that belong to a person or corporation, Chinese trust companies' business is devoted to the provisioning of nonstandard credit (i.e., risky lending to corporate borrowers that prudential rules prevent banks from lending to directly). Chinese trust companies cooperate closely with banks to channel the proceeds of bank-issued wealth management products into trust products, thereby gaining access to retail depositors who could not normally afford to invest in trust products. Chinese trust companies' main function, therefore, is to perform bank-style credit intermediation but with a lower regulatory compliance threshold. Chinese trust companies' assets thus include risky, high-yield products backed by loans that are sold to banks, institutional investors, and wealthy individuals. According to one former executive of a Chinese securities company, these pyramid-like products are essentially "bank loans with an investment wrapper [provided by a trust company, securities company, or fund management company] around them to allow them to be booked as investments." Charlie Zhu et al., "Key Part of China's Shadow Banking Faces Doubling of Defaults," Bloomberg, April 14, 2020; Jason Bedford and May Yan, "Shining a Light on Shadow Banking: The Trust Sector Leads the Way on Easing in Shadow Banking," UBS, March 26, 2019, 3–6.
†The China Trustee Association provides no definition of what qualifies a particular asset as "at risk" or how this may differ from the more widely used "nonperforming asset" designation. The figure likely only counts assets that have exhibited obvious problems (e.g., they have defaulted). Allen Feng and Logan Wright, "The Shadow Iceberg," Rhodium Group China Markets Research, May 19, 2020, 4.
er $762.7 billion (RMB 5.4 trillion) in trust products comes due in 2020.

**Challenges in China’s Financial System and Beijing's Policy Responses**

The fourfold expansion of China’s financial system after the global financial crisis helped China avoid a recession, but it also amplified preexisting structural distortions in the way financial resources are allocated and led to the accumulation of significant risks on financial institutions’ balance sheets. Diffusing these risks increasingly requires new capital formation, which China’s financial system is poorly positioned to provide efficiently. With China recording its first economic contraction in decades in the first quarter of 2020, a growing list of local governments, SMEs, and struggling banks need to be bailed out or recapitalized. Meanwhile, China’s balance of payments position is deteriorating amid looming demographic challenges. Addressing these challenges without exacerbating China’s debt burden is a major obstacle for policymakers and a key factor driving Beijing to view foreign investors as part of the solution.

**Government Interference and Implicit Guarantees**

Despite repeated promises to allow the market a greater role in guiding the economy, China’s leaders continue to prize economic and employment stability and control ahead of market independence. Beijing has therefore intervened wherever it has deemed necessary to prevent bankruptcies, defaults, and financial losses. The government has thereby fostered an expectation that it will effectively bail out any financial institution or state-owned company that is in danger of default. This unacknowledged assurance of government support is often called an “implicit guarantee.”

Implicit guarantees have led creditors, investors, and the Chinese public more generally to base their assessment of any particular company or financial institution’s ability to repay debt not on its actual fundamentals, but rather on the strength of the government’s appetite and capacity for intervention. After the global financial crisis, implicit guarantees were a key ingredient for China’s rapid debt buildup because they incentivized local governments and companies to binge on cheap credit to bolster flagging growth and push through local projects that otherwise would have been difficult to finance. Banks and other financial institutions, meanwhile, could take advantage of loose monetary policy conditions to churn out large volumes of “risk free” loans.

**Attempts to Break the Implicit Guarantee Flounder**

Financial regulators are aware of the distorting effect implicit guarantees have on credit allocation and have made tentative attempts to begin rolling them back amid a broader financial cleanup campaign that began in late 2016. But doing so requires regulators to successfully navigate creditor jitters by seeking to punish risk-taking behavior only where it is least disruptive to overall financial markets. Regulators have made moderate attempts to roll back the implicit guarantee in two areas: the banking sector and the corporate bond market.
Implicit Guarantees in the Banking Sector

Before 2019, Beijing’s attempts to roll back the implicit guarantee in the banking sector failed completely. The May 2019 government takeover of Baoshang Bank was the first credit event in more than two decades that significantly altered banks’ approach to risk. Financial regulators underestimated the severity of the market reaction to their Baoshang experiment, however, leading them to backtrack in their treatment of subsequent bank failures. This has produced an ambiguous set of outcomes, the long-term implications of which remain unclear.

On May 24, 2019, the CBIRC announced it would take direct control over Baoshang Bank through a one-year receivership.* Two days later, the People’s Bank of China (PBOC) announced it would force interbank creditors with exposures in excess of $7.1 million (RMB 50 million) to accept losses up to 30 percent.† Although the PBOC tried to present Baoshang as an isolated case, a number of other regional banks faced similar challenges. Therefore, Chinese interbank markets reacted by hiking the premium on short-term loans to banks with similar risk profiles. This is visible in the significant interest rate spread that suddenly appeared in the Negotiable Certificate of Deposit (NCD)‡ market following the Baoshang takeover (see Figure 3). After Baoshang, banks with credit ratings below AAA experienced a significant funding squeeze.§


‡Negotiable certificates of deposit are a commonly used instrument for high-volume, short-term borrowing in interbank markets. From 2013 (when NCDs were introduced in China) to 2018 the volume of annual NCD issuance grew rapidly from $153.5 billion (RMB 950 billion) to $770.3 billion (RMB 5.3 trillion). Regional banks became especially reliant on these and other interbank funding sources. According to Chinese media reports, Baoshang’s interbank liabilities accounted for about 44 percent of its total liabilities before the bailout, a significant portion of which were in NCDs. Yang Jiao, “City Commercials Banks’ Sickness of Reliance on Interbank Markets Continues, Regulators Focus on Liquidity Risks at Small and Medium Banks” (城商行同业依赖症不减，监管关注中小银行流动性风险), Yicai, May 27, 2019. Translation. https://www.yicai.com/news/100263059.html; Yin Ruizhe and Li Yuze, “Will the Baoshang Bank Incident Shock Credit Markets?” (包商银行事件会冲击信用债市场吗?), China Merchants Securities, May 26, 2019. Translation. http://www.newone.com.cn/research/read/231224; People’s Bank of China, China Banking and Insurance Regulatory Commission, China Central Depository and Clearing Company, and Shanghai Clearing House via CEIC database.

Figure 3: Three-Month NCD Yields by Credit Rating, February 2019–January 2020

The spread on funding costs between different banks did not return to pre-Baoshang bailout levels until the fourth quarter of 2019. By this time, Beijing had bailed out several other banks at no cost to creditors. In total, six banks have received government assistance in the year and a half since Baoshang, with no creditors suffering losses (for a list complete through September 2020, see Addendum I: Chinese Government Interventions into Financially Distressed Banks, 2019–2020). The long-term implications of government actions in these bailouts are highly ambiguous. In one sense, subsequent bank rescues have restored some of the confidence in the implicit guarantee that was shaken by Baoshang. At the same time, city commercial banks have clearly internalized some of the lessons from the Baoshang bailout and have since displayed less appetite for risk, as demonstrated by reduced asset growth. Between May and December 2019, asset growth at city commercial banks slowed from 12.4 percent year-on-year to 8.5 percent. This occurred at a time of accelerating asset growth for large state-owned banks and national joint-stock banks. The year 2019 also saw the first annual contraction in NCD issuance since the PBOC first approved the instrument’s use in 2013.

Implicit Guarantees in the Corporate Bond Market

Another arena where Beijing is relaxing the implicit guarantee is the corporate bond market. In 2019, China saw a record number of bond defaults (see Figure 4), including several high-profile credit events. For example, in December, Tewoo Group, a large state-owned commodities company based in Tianjin, became the first SOE to default on dollar-denominated debt in more than two decades. Officially estimated at $1.1 trillion as of March 2020, China’s total dollar-denominated foreign obligations are relatively small compared to China’s overall debt, which the Bank for Internation-
same month, Inner Mongolia-based Hohhot Economic and Technological Development Zone Investment Development Group nearly became the first local government financing vehicle (LGFV) to default when it missed a payment on a privately issued bond. Analysts expect defaults to rise further in 2020, with $918.1 billion (RMB 6.5 trillion) in payments coming due for Chinese corporate bond issuers.

Chinese regulators have aided borrowers in using a variety of creative techniques to avoid technical defaults, roll over debt, and extend repayment periods. This has not eased repayment risks but rather merely reduced headline default numbers. For example, 16 Chinese companies rated by Fitch Ratings defaulted on onshore bonds with a principal value of $7.4 billion (RMB 52.5 billion) in the first six months of 2020, a decline from 35 companies involving $10.3 billion (RMB 72.7 billion) in defaults in the same period in 2019. Repayment risks remain heightened as the economic impact of COVID-19 has compounded the strain on corporate finances.

Figure 4: Chinese Interbank Bond Market Defaults, 2014–2019

Though rising corporate bond defaults are partially an indication of Beijing’s increased tolerance for credit events as it seeks to loosen the implicit guarantee, the composition of defaulting borrowers...
suggests the state remains reluctant to let SOEs fail.\textsuperscript{46} For example, private companies issued just 7.7 percent of onshore corporate bonds in 2019 but accounted for 80 percent of defaults that same year.\textsuperscript{47}

**Beijing Seeks to Resolve Uneven Financing Environment**

An unintended consequence of Beijing’s financial de-risking campaign that began in late 2016 was that small private companies were disproportionately affected.\textsuperscript{48} Due to the implicit guarantee and continuing government influence of interest rates, banks prefer to lend to large SOEs, which, even if not profitable, are much less likely to default than small private companies. Beijing has sought to address the private sector’s funding challenges from multiple angles. The years 2019 and 2020 saw some progress on capital market reforms intended to loosen banks’ grip on the economy, though these reforms have focused on equity rather than bond financing. At the same time, Beijing instructed banks to step up their lending to small businesses and eased monetary policy to encourage them to do so. The PBOC engaged in incremental capital market reforms and limited interest rate reforms to further improve its ability to guide credit allocation.

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**China’s Corporate Landscape: SOEs, Private Companies, and the Question of Control**

China’s so-called private companies play an instrumental role in the economy, accounting for 60 percent of GDP, 80 percent of urban employment, and 90 percent of new job creation.\textsuperscript{49} Though these ostensibly private companies occupy important roles in China’s economy, they also respond to both market and nonmarket incentives and therefore do not necessarily operate in the same way as private companies in the United States. Many have intimate links to the Party and government, receive preferential access to financing and subsidies, and sometimes align their commercial operations with CCP objectives. For example, as COVID-19’s global spread accelerated in March 2020, large private companies like Huawei and Alibaba dispatched personal protective equipment (PPE) to countries where the Party seeks to expand its influence or cultivate new markets.\textsuperscript{*}

In September, the CCP moved to further strengthen its leadership and control over the private sector by extending the work of the United Front Work Department\textsuperscript{†} further into the business community. According to the *Opinions on Strengthening the United Front Work of the Private Economy in the New Era*, the United

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\* Huawei donated 800,000 face masks to the Netherlands in mid-March 2020. The Netherlands is slated to auction its 5G network buildout in 2020, suggesting Huawei’s efforts are politically motivated. Separately, the Jack Ma Foundation, founded by former executive chairman of e-commerce giant Alibaba, promised to send PPE to all 54 African nations, where the Chinese government seeks to deepen its political influence and expand economic engagement. David Hutt, “China’s ‘Mask Diplomacy’ in Pandemic-Hit Europe Stirs Unease,” *Nikkei Asian Review*, March 25, 2020; Samuel Gebre, “China Expands Medical Aid to Africa with First Ethiopia Shipment,” *Bloomberg*, March 22, 2020.

\† The United Front Work Department is a Chinese government entity charged with extending the CCP’s influence and control over non-Party organizations both domestically and abroad to advance CCP policy objectives. For more on the United Front Work Department, see Alexander Bowe, “China’s Overseas United Front Work: Background and Implications for the United States,” *U.S.-China Economic and Security Review Commission*, August 24, 2018.
China’s Corporate Landscape: SOEs, Private Companies, and the Question of Control—Continued

Front’s work with the private sector is “an important way to realize the Party’s leadership over the private economy.” The policy correspondingly calls for improving coordination between private enterprises and the government and strengthening Party-building activities in private enterprises, among other things. Some of these enterprises may be raising capital on U.S. exchanges. Separately, recent research reveals privatized SOEs “enjoy lower interest rates, larger loan facilities, and more subsidies” than private companies that were never state owned. In addition to links between the government and individual companies, there are also structural factors that muddy the state-private distinction. The Chinese government’s expansive influence over Chinese firms creates what analysts have referred to as a “national strategic buyer” problem, whereby decisions made by Chinese companies—be they nominally private or state owned—may be guided by national security or industrial policy objectives.

Development of China’s Stock Market Outpaces Bond Market

Beijing is taking gradual steps to further develop its capital markets and achieve its twin ambitions of encouraging Chinese companies to list at home rather than abroad, drawing in ever greater amounts of foreign capital to alleviate debt pressures. In 2019 and 2020, regulators adopted measures to enhance the attractiveness of the domestic stock market to encourage Chinese companies to list in the Mainland. A key plank of this effort was the establishment of a Nasdaq-style Science and Technology Board on the Shanghai Stock Exchange, known as the STAR Market, with the Chinese government keen to incentivize China’s high-tech and most profitable companies to list in China rather than in Hong Kong (such as Tencent) or New York (such as Alibaba and Baidu).

While the STAR Market focuses narrowly on attracting high-tech companies that align with national development priorities, its eased listing provisions are being extended to China’s other stock exchanges in a “step-by-step” fashion through amendments to the country’s Securities Law. The revised law went into effect in March 2020 and calls for the registration-based initial public offering (IPO) system, first piloted on the high-tech board, to apply across all Chinese exchanges. In addition, the minimum business requirement for a company to qualify for a new listing is lowered to “being capable of business operations” from the previously more stringent “capable of sustained profitability,” technically enabling money-losing startup companies to list.

In June 2020, the CSRC finalized rules extending the registration-based IPO system to Shenzhen’s ChiNext Board, a trading venue for tech startups on the Shenzhen Stock Exchange. A first batch of 18 technology startups debuted on the board under the

revamped system on August 24, with stocks surging 200 percent on average. Unlike the registration-based IPO system piloted on the STAR Market, the changes to the ChiNext Board apply to secondary offerings and acquisition and merger deals involving a far wider array of companies. The measures could result in a wave of IPOs and secondary offerings on the Shenzhen Stock Exchange, which has featured fewer offerings than the Shanghai Stock Exchange since the STAR Market’s debut there. These measures could also heighten competition between the two exchanges as they pursue listings from Chinese technology startups.

Beijing has tried to foster more dynamic domestic bond markets by encouraging participation beyond state-owned banks, LGFVs, SOEs, and other government-affiliated entities that have dominated bond issuance. Initially, only SOEs and companies listed on Chinese exchanges were allowed to issue bonds, though the CSRC updated its regulatory framework in 2015 to allow bond issuance by both listed and unlisted companies. Though access has been eased, private enterprises still face difficulty issuing bonds and have to pay higher interest rates than SOEs on similarly rated bonds. Additionally, banks hold the majority of bonds in domestic fixed income markets and trade them infrequently. This makes the bonds little more than disguised bank loans and reduces market liquidity.

Beijing Leans on Banks to Boost Private Sector Lending

In March 2019, facing a significant slowdown in the pace of economic growth, Beijing ordered banks to increase their lending to small and micro enterprises, in this case defined as those with a credit line of less than $1.4 million (RMB 10 million), by 30 percent in 2019. For 2020, the government has demanded that the six largest banks increase lending to such enterprises by 40 percent. To boost liquidity in the banking system, the PBOC has also made several cuts to both the benchmark interest rate and the reserve requirement ratio (RRR), or the percentage of deposits banks must keep in reserve either as cash in their vaults or deposited with the central bank. Over the past two years, the PBOC has cut the

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*The Chinese government sets criteria distinguishing micro-, small-, and medium-sized enterprises on a sector-by-sector basis according to operating revenue, number of employees, total assets, and other factors. These criteria vary significantly within and across sectors. For example, in the retail sector, firms with fewer than 10 employees are micro-sized enterprises, 10–50 employees are small-sized enterprises, and more than 50 employees are medium-sized enterprises. Contrastingly, in the industrial sector, firms with fewer than 20 employees are micro-sized enterprises, 20–300 employees are small-sized enterprises, and more than 300 employees are medium-sized enterprises. Though definitionally fluid, these smaller companies are important to China’s economic health. According to Chinese state media, “Private enterprises dominated by small, medium, and micro enterprises” account for 60 percent of GDP, 80 percent of urban employment, and half of national tax revenue.


†The shift to a target that only applies to the six major state-owned banks may reflect the fact that the Big Six undercut other banks by offering cheaper loans in order to meet their targets. Liu Meng, “Policy Continues to Support Small and Micro Enterprises, Last Year Inclusive Lending by the Six Major Banks Exceeded RMB 3 Trillion” (政策持续加持小微企业 六大行去年普惠小贷超3万亿元), Securities Daily, April 1, 2020. Translation. http://www.zqrb.cn/finance/hongguanjingji/2020-04-01/A1585662956388.html; Sun Yu, “China Boosts Lending to Small Businesses despite Risk,” Financial Times, December 29, 2019; Wu Hongyuran and Timmy Shen, “Banks Go to War to Meet Beijing’s Goal of Lowering Rates for Small Businesses,” Caixin, May 16, 2019.
RRR nine times, from 13.1 percent in September 2018 to 9.4 percent in April 2020. The central bank also began cutting lending rates in the second half of 2019. Between November 2019 and April 2020, the PBOC cut the rate on its Medium-Term Lending Facility (MLF) three times, from 3.15 percent to 2.95 percent. The Loan Prime Rate (LPR), which is not directly set by the PBOC but is linked to the MLF, has also fallen from 4.25 percent in August 2019 to 3.85 percent in May 2020.

### Modifying China’s Interest Rate System

In 2019, China’s central bank adjusted its interest rate regime, ostensibly in an effort to drive bank lending rates to become more market determined. In August 2019, the PBOC revamped the way it determines the LPR in a bid to place it at the center of China’s interest rate regime. The LPR is a nominally market-determined reference rate based on the average of the rates offered by ten large commercial banks to their best customers. The PBOC now also considers quotations from eight additional commercial banks in addition to the existing ten, including two foreign banks and two online banks. The notice announcing the reform also directed the 18 participating banks to submit quotations in terms of their spread over the MLF rather than the benchmark rate. Following this change, the PBOC announced in December 2019 that banks must begin pricing floating interest rate loans according to the new LPR by January 1, 2020. It also ordered banks to reprice more than $21.5 trillion (RMB 152 trillion) of preexisting loans according to the LPR by March 2020.

Although the stated aim of the 2019 LPR reforms was to give greater weight to the market in setting interest rates, analysts disagree about factors contributing to the decision. One factor, cited by the PBOC itself as a secondary motivation, was to reduce borrowing costs for SMEs in the short term. This is because the MLF interest rate (3.3 percent) was significantly lower than the benchmark rate (4.35 percent) at the time the change took effect. But observers have proposed other motivations as well. In testimony before the Commission, Zhiguo He, financial markets expert and professor of finance at the University of Chicago Booth School of Business, argued the LPR reform was largely aimed at improving monetary policy transmission to the real economy by removing the opportunity for banks to collude by coordinating

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*Alongside reverse repurchase agreements and the Standard Lending Facility, the MLF is a monetary policy tool the PBOC uses to increase liquidity in the banking system. As the name suggests, the MLF consists of PBOC loans to the banking sector of a medium-term maturity (i.e., between three months and one year). Bloomberg, “China’s Evolving Toolkit to Manage Monetary Policy,” June 7, 2019.


§ A floating interest rate—as opposed to a fixed interest rate—is one that fluctuates according to the market as represented by an index. Previously, floating interest rate loans were indexed against the benchmark lending rate. Kevin Yao, “China to Switch Benchmark for Floating-Rate Loans to Lower Funding Costs,” Reuters, December 27, 2019; Financial Industry Regulation Authority, “Can You ‘Float’ with Rate Hikes? 6 Things to Know about Floating-Rate Loan Funds.”
the interest rates they report. Because the banks must quote a spread over the MLF, an instrument directly set by the PBOC through open market operations, the PBOC can simply cut the MLF to bring down borrowing costs regardless of whether the LPR reporting banks have colluded. Carl Walter, former chief operating officer of JPMorgan China, described the reform less favorably as a way of “preventing banks from charging high interest rates in a nominally market-based environment.”

Although lending quotas, RRR cuts, and interest rate cuts have spurred lending to small companies (the government claims a 25 percent increase in 2019), this may be fueling the creation of NPLs rather than generating productive investment. The NPL ratio of small and micro enterprises is significantly higher than the national average: officially 3.3 percent compared to 1.9 percent, though the actual numbers are likely much higher for both categories. Before the COVID-19 pandemic, many of the strongest-performing small businesses declined loans due to the lack of profitable investment opportunities.

**Debt Burden Spurs Disposals of NPLs**

The corollary to China’s massive financial expansion after the global financial crisis was rapid debt accumulation. Between the end of 2008 and the second quarter of 2020, China’s debt burden grew from 139 percent of GDP to 283 percent of GDP—a scale and speed unprecedented in modern history. A risk related to China’s debt buildup was the undercounting of NPLs on bank balance sheets. Officially, China’s NPL ratio was only 1.9 percent in the fourth quarter of 2019, but this number significantly understates the true extent of NPLs.

Historically, banks have used a variety of methods to disguise NPLs on their balance sheets and thereby avoid complying with loan-loss provisioning requirements (currently set between 120 percent and 150 percent of NPLs), which would constrain their lending capacity. One method was to use accounting discretion to classify loans more than 90 days overdue as “overdue but not impaired.” Another common practice was to collaborate with nonbank financial institutions such as trust companies or securities brokerages to move loans off balance sheet and repackage them as investment products, which carry lower risk weightings and thus require less capital provisioning. Such understating of NPLs is obvious when comparing the official NPL numbers banks report with annual NPL disposal numbers published by the CBIRC. For example, in 2018 Chinese banks reported disposing of more NPLs ($283.2 billion)

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*Open Market Operations (OMO) refer to when a central bank buys or sells securities to qualified banks on the open market to influence the money supply. In China, OMO also comprises other lending facilities such as the MLF. Since the MLF is simply a loan from the PBOC to a major bank, the PBOC can set the interest rate on the loan.

†The largest component of China’s debt profile is corporate debt, which stood at 159.1 percent of GDP in the first quarter of 2020. Government debt was 58.2 percent of GDP and household debt was 57.2 percent of GDP. Bank for International Settlements, “Credit to the Non-Financial Sector,” September 14, 2020.
than they supposedly had on their balance sheets at the beginning of the year ($242.2 billion). 86

The high volume of unrecognized NPLs means China’s banks are effectively undercapitalized, holding insufficient capital to cover foreseeable repayment risks associated with their risky loans. As Dinny McMahon, former Wall Street Journal reporter and expert on China’s debt issues, testified before the Commission, if banks recognized these NPLs for what they actually are they “would have to immediately raise huge amounts of capital, all at once, and at fire sale prices.” 87 The tightening of NPL disclosure requirements in 2018 and 2019 threatened to precipitate just such a crisis for many undercapitalized banks, spurring them to accelerate NPL disposals. 88 Chinese banks, with the assistance of the central and local governments, are addressing their NPL problem in four main ways:

- **Asset Management Companies:** Asset Management Companies (AMCs) specialize in acquiring NPLs and either extracting value from them or reselling them on secondary markets to both domestic and foreign investors.* China’s first four AMCs were established in 1999 amid an earlier government bailout of big banks, and they continue to operate today. 89 In 2013, China began piloting regional AMCs to augment the NPL disposal capacity of the four central AMCs. Regional AMCs quickly became major players in the NPL disposal business and proliferated from an initial batch of five to a total of 61 companies by the end of 2018 as provinces clamored to establish their own. 90 For banks looking to offload large volumes of NPLs quickly, selling them to AMCs at a discount from face value remains the primary disposal method available, but China’s NPL problem is too large to be resolved by the use of AMCs alone. In fact, a brief speculative bubble that emerged around rising NPL disposals in 2017 quickly proved unsustainable and crashed NPL prices when it burst in early 2018. 91

- **Securitization:** Since 2016, Beijing has piloted an NPL securitization program, permitting select Chinese banks to sell asset-backed securities with NPLs as the underlying assets. In November 2019, Chinese media reported that financial regulators would allow additional domestic banks, the four national AMCs, and Standard Chartered Bank to participate in the pilot. 92 Although the volume of securitized NPLs remains small— as of December 2019 the cumulative value was $9.7 billion (RMB 68.7 billion)—financial regulators clearly envision them playing a supporting role in NPL disposal. 93

- **Foreign investors:** The Phase One U.S.-China trade agreement signed in January 2020 allows U.S. distressed asset managers to apply for licenses to establish provincial-level

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*Municipal financial authorities in Shanghai have approved the establishment of two wholly foreign-owned AMCs since 2017. Unlike national AMCs, these foreign AMCs cannot purchase NPLs directly from Chinese banks and financial institutions and must instead purchase them through secondary market transactions. Such wholly foreign-owned AMCs that only participate in China’s secondary NPL markets are commonly referred to as “non-licensed” AMCs. See Richard Mazzochi et al., “China’s NPL and ABS Markets: A Guide to Foreign Investors and Financiers,” King & Wood Mallesons, April 2019, 4.
AMCs within China and to acquire NPLs directly from Chinese banks. As foreign distressed debt investors previously could only acquire Chinese NPLs on secondary markets, this part of the agreement potentially opens up a significant new channel through which Chinese banks can dispose of NPLs. Los Angeles-based Oaktree Capital Management subsequently became the first U.S. company to set up a wholly owned unit in Beijing. At a press briefing in March 2020, CBIRC chief risk officer Xiao Yuanqi suggested the agreement could lead to greater numbers of foreign AMCs establishing themselves in China. While this development was welcomed by U.S. distressed asset investors, it contains additional risks. For example, when Chinese banks sell securitized NPLs, they typically act as both underwriter and debt servicing agent. This creates a conflict of interest. Underwriting banks, which often securitize their own NPLs, have both better information than foreign investors on what the loans are worth and an incentive to price them below market rates. When the securitized NPL then outperforms, the underwriting bank receives almost all of the benefit through performance fees and commission income.

- **Loan forbearance:** The COVID-19 pandemic has exacerbated banks’ NPL problem by eroding borrowers’ financial positions and damaging their ability to repay loans. In a May 2020 interview, PBOC Governor Yi Gang admitted that banks could face a “large increase” in their NPL ratios and elevated “disposal pressure.” The government responded by declaring a moratorium on NPL recognition and forcing banks to exercise forbearance for certain types of businesses, primarily small, medium, and micro enterprises that are at risk of closing permanently. In March 2020, the CBIRC ordered banks to extend repayment periods for small businesses to June 30, 2020, and allowed them to postpone NPL recognition until after that date. In May 2020, Beijing extended loan repayment for these companies until the end of March 2021. These measures allow banks to temporarily delay addressing rising NPL ratios that would otherwise force banks into an asset fire sale and threaten the stability of the banking sector.

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† In an August 2020 interview with state-run news outlet Xinhua, CBIRC Chairman Guo Shuqing estimated China’s banks will need to dispose of $480.2 billion (RMB 3.4 trillion) in 2020, up 47.8 percent from the $324.9 billion (RMB 2.3 trillion) disposed of in 2019. *Xinhua,* “Fully Support the Economic and Social Recovery and Firmly Adhere to the Bottom Line of Risk—Interview with PBOC Party Secretary and CBIRC Chairman Guo Shuqing” (全力支持经济社会恢复发展 牢牢守住风险底线——访中国人民银行党委书记、中国银保监会主席郭树清), August 13, 2020.
Narrowing Current Account Surplus and Demographic Challenges

China has long maintained a current account* surplus, but it has trended downward over the past decade as China's historically high national savings rate has weakened and investment has moderated. A weaker national savings rate, due in part to an aging population, has decreased the savings-investment gap, with savings declining at a faster pace than investment.\textsuperscript{102} Analysts note that an uptick in households' consumption of goods and services, particularly outbound tourism, has further contributed to the decline in household savings.\textsuperscript{103} For example, according to World Bank estimates, Chinese tourists spent $277.3 billion on outbound travel in 2018, a nine-fold increase from $29.8 billion in 2007.\textsuperscript{104} Together, these factors have contributed to the narrowing gap between China's national savings and investment and dragged China's current account surplus down from a peak of 10 percent of GDP in 2007 to a deficit of $28.3 billion (or 1.1 percent of GDP) in the first half of 2018.\textsuperscript{†} \textsuperscript{105} Though China is expected to register a current account surplus in 2020 due to a sharp decline in outbound tourism flows as a result of the COVID-19 pandemic, economists maintain that a structural shift toward a persistent current account deficit is likely over the coming decade.\textsuperscript{106}

The International Monetary Fund anticipates the downward trend in China's national savings will continue as China's population ages. Household savings, which account for roughly half of national savings, are expected to decline by 6 percentage points by 2030 as fewer workers rely on their savings to support more retirees.\textsuperscript{107} According to UN forecasts, by 2045 China's working-age population will drop to 54.4 percent of China's total population (compared to 65 percent today), while the country's population over 60 will grow to 31.4 percent of the total population (compared to 17.4 percent today).\textsuperscript{108} A 2019 report from the Chinese Academy of Social Sciences warned China's declining birth rate—a legacy of the “one-child policy”—and simultaneous increase in life expectancy will exacerbate these trends, leading the country's national pension fund‡ to become in-

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\* The current account balance refers to the balance of trade plus net (investment) income from abroad and net transfer payments. The current account is one half of the balance of payments; the other half is the capital account. Economists often refer to the current account as the difference between savings and investment because this is arithmetically equivalent.

† China first recorded full-year and half-year current account deficits in 1993 and 1998, respectively. State Administration of Foreign Exchange via CEIC database.

‡ China features a multilayered pension system. The first layer consists of several public pension schemes, some mandatory (Basic Old Age Insurance and Public Employee Pension) and some voluntary (Urban Resident Pension and New Rural Resident Pension). These schemes provide basic social security to all residents when they retire, regardless of whether they were employed. At the end of 2019, these public pension schemes had more than 967 million participants, accounting for 69.2 percent of China's total population. In aggregate, these schemes paid out RMB 5.2 trillion (RM 734.5 billion) to 123.1 million retirees that same year, with monthly payments averaging $487.71 (RM 3,453) per retiree. These aggregate numbers likely mask regional disparities and inequality in pension benefit payments to urban versus rural residents. Differing wage and income levels across China's provinces between these cohorts create divergences in their voluntary contributions, while variations in local governments' fiscal revenues can limit the ability of poorer provincial governments to contribute to pension funds. Orange Wang, "China's Ageing Rural Peasants Labor into Their Twilight Years as Pensions 'Cover Only Oil and Salt,' " \textit{South China Morning Post}, August 22, 2020; China's Ministry of Human Resources and Social Security, \textit{2019 Statistical Bulletin on Human Resources and Social Security Development} (2019 年度人力资源和社会保障事业统计公报 中华人民共和国人力资源和社会保障部), June 6, 2020, 5. Translation. \texttt{http://www.mohrss.gov.cn/SYrlzyhshbzbu/wz/zyrz/zy/jypf/202006/W020200608534464798832.pdf}; Hamming Fang and Jin Feng, "The Chinese Pension System," (draft) in Marlene Amstad, Guofeng Sun, and Wei Xiong, eds., \textit{The Handbook of China's Financial System}, forthcoming Pric
solvent by 2035.\textsuperscript{109} Fiscal stimulus measures enacted by Beijing to help companies weather the COVID-19 outbreak included a government pledge to reduce or exempt companies across the country from pension contributions.\textsuperscript{110} The lower contributions will lead to even faster depletion of the national pension fund.

The strain of demographic pressures\textsuperscript{*} on national savings and government coffers, together with mounting prospects for persistent current account deficits, is pushing the Chinese government to look abroad for capital. Analysts at Morgan Stanley estimate China will need at least $210 billion of net foreign capital inflows per year through 2030 to finance the country’s emerging current account deficit.\textsuperscript{111} To facilitate these inflows, the Chinese government is expanding foreign investor access to its capital markets. In testimony before the Commission, Mr. Loevinger stated that financial opening seeks to: (1) address the drawdown on national savings as China’s population ages and (2) offset dwindling foreign direct investment flows and increases in China’s outbound investment to stabilize the country’s balance of payments more broadly.\textsuperscript{112} Derek Scissors, resident scholar at the American Enterprise Institute, added that these dynamics will prompt Chinese officials to attract and draw in U.S. capital “for years to come.”\textsuperscript{113}

**Risks of China’s Integration with Global Financial Markets**

Though the Chinese government long limited foreign access to its financial markets, capital stress, together with ambitions to internationalize China’s financial markets and improve the competitiveness of domestic financial services firms, has led Beijing to implement market opening measures gradually in recent years. As a result, the global economy’s exposure to risks in China’s financial system is rising. These risks center around China’s opaque political structure, faulty or misleading data reporting, and systemic problems ailing its financial system. Furthermore, they expose overseas investors to vulnerabilities in China’s economy. Of added concern to the United States is that increased flows of U.S. investment dollars to Chinese entities contradict concurrent U.S. policy objectives vis-à-vis China.

**China’s Financial Opening**

Financial opening has been accelerating in China in recent years. At the April 2018 Boao Forum for Asia, General Secretary of the CCP Xi Jinping and PBOC Governor Yi announced the Chinese government would deliver on long-overdue pledges first made when China joined the WTO in 2001 to open China’s financial sector to

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\textsuperscript{*} A rapidly aging population in China, compounded with a steadily shrinking workforce, will complicate China’s growth prospects in the future. While China’s large and relatively cheap labor force has underpinned the country’s economic growth to date, growth moving forward will need to be generated from capital services and productivity improvements. The Chinese government has tried in recent years to counter these demographic trends by easing enforcement of the “one child” policy in 2013 and then raising the limit to two children for all families in 2016, but China’s birth rate has continued to decline. In 2018, the total number of births fell to 15.2 million, a drop of nearly 12 percent nationally from 2017. Steven Lee Myers, Jin Wu, and Claire Fu, “China’s Looming Crisis: A Shrinking Population,” *New York Times*, January 17, 2020; Andrew Polk, written testimony for the U.S.-China Economic and Security Review Commission, *Hearing on U.S.-China Relations in 2019: A Year in Review*, September 4, 2019, 10.
foreign competition. Since then, Beijing has taken several steps to (1) increase market access in the banking, securities, and insurance industries; (2) grant foreign institutions equal treatment in credit and payment sectors; and (3) open the domestic bond market to foreign investors. (For more on China’s financial opening and related commitments made as part of the U.S.-China Phase One trade agreement, see Chapter 2, Section 1, “Year in Review: Economics and Trade.”)

Beijing’s strategic financial opening efforts are more tightly integrating Chinese securities with global financial markets. This is most visible in the growing inclusion of Chinese securities in several key global investment indices, against which an estimated $7.8 trillion in assets under management are currently benchmarked. (For a more detailed review of these inclusions, see Addendum II: Global Investment Index Providers’ Inclusion Schedules for Chinese Securities.) China’s government has carefully calibrated market opening to secure these inclusions and facilitate foreign capital inflows to support its ailing economy.

Before index inclusions, foreign investors’ primary channels for accessing China’s financial markets were the Stock and Bond Connect programs, which, according to Logan Wright of Rhodium Group, enabled net foreign inflows of approximately $26.2 billion in 2016 and $48.5 billion in 2017. In April 2018, the CSRC raised the daily northbound quota (the value that individual Hong Kong and overseas investors can trade in Chinese securities through Hong Kong) for the Stock Connect program from $1.8 billion to $7.2 billion. This led to the inclusion of A-shares into several benchmark MSCI and FTSE Russell indices in 2018–2020.

The Chinese government has also endeavored to remove lingering obstacles to similar inclusions into global fixed income indices. In September 2018, regulators rolled out Delivery versus Payment (DvP) settlement for the Bond Connect, removing a key source of risk for foreign investors. Two months later, China’s State Taxation Administration announced that foreign bond investors would enjoy a three-year exemption from corporate and value-added taxes. Collectively, these policy shifts addressed concerns around

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† The Stock and Bond Connect programs, launched in 2014 and 2017, respectively, enable overseas investors with accounts in Hong Kong to trade stocks and bonds on the Shanghai and Shenzhen exchanges. UBS, “China Fixed Income: What is Bond Connect?” June 8, 2020; Goldman Sachs, “The Stock Connect,” December 2016.

‡ A-shares are RMB-denominated securities of companies incorporated in China that trade on either the Shanghai or Shenzhen stock exchanges. A-share trading is restricted to Chinese residents, and foreigners can only access the A-share market through special investment programs such as the Qualified Foreign Institutional Investor program and the Stock Connect programs. A-shares are distinct from other Chinese share classes such as H-shares (shares in Chinese incorporated companies listed on the Hong Kong Stock Exchange), trading of which is not restricted to Chinese residents. FTSE Russell, “Guide to Chinese Share Classes,” May 2019.

§ DvP is a securities industry settlement method that guarantees the transfer of securities only happens after payment has been made. It stipulates that the buyer’s cash payment for a security must be made prior to or at the same time as the delivery of the security. The process is meant to reduce the risk that securities could be delivered without payment or that payments could be made without the delivery of securities. Kate Jacquet, “The Evolution of China’s Bond Market,” Seafarer Funds, March 2019, 9, 28.
investor confidence and market accessibility that were raised by Bloomberg and other index providers, resulting in a wave of inclusions of Chinese securities over the last two years.\textsuperscript{122}

**Index Inclusions Increase Foreign Holdings of Chinese Securities**

Five major index providers have announced or begun implementing inclusions of Chinese securities into key global indices (see Figure 5).\textsuperscript{*}

*The rising inclusion of Chinese securities in global investment indices coincides with a shift in the asset management industry from active to passive investment strategies. In an active investment strategy, individual investors or portfolio managers buy or sell individual stocks. Such an investment approach requires individual investors or the managers overseeing their portfolios to closely follow market activity and particulars of specific companies. Contrastingly, in a passive investment strategy, investors instead invest in an index fund whose composition of stocks and bonds reflects a market benchmark, such as the S&P 500. This allows the index fund to track the performance of a group of companies, demanding less scrutiny and research by investors and portfolio managers. Investment index providers develop an array of investment benchmarks against which a passive investor’s portfolio can be tracked. Kenechukwu E. Anadu et al., “The Shift from Active to Passive Investing: Potential Risks to Financial Stability?” Federal Reserve Bank of Boston, 2018.*

\textsuperscript{*}The rising inclusion of Chinese securities in global investment indices coincides with a shift in the asset management industry from active to passive investment strategies. In an active investment strategy, individual investors or portfolio managers buy or sell individual stocks. Such an investment approach requires individual investors or the managers overseeing their portfolios to closely follow market activity and particulars of specific companies. Contrastingly, in a passive investment strategy, investors instead invest in an index fund whose composition of stocks and bonds reflects a market benchmark, such as the S&P 500. This allows the index fund to track the performance of a group of companies, demanding less scrutiny and research by investors and portfolio managers. Investment index providers develop an array of investment benchmarks against which a passive investor’s portfolio can be tracked. Kenechukwu E. Anadu et al., “The Shift from Active to Passive Investing: Potential Risks to Financial Stability?” Federal Reserve Bank of Boston, 2018.
Key Risks of Rising U.S. Investor Exposure to Chinese Securities

Lack of Transparency

China’s opaque political structure and systemic problems in its economy heighten the risks posed by investing in Chinese stocks and bonds. The Chinese government’s perennial focus on maintaining financial stability and its corresponding propensity toward market intervention inhibit price signals and limit transparency. Forms of this intervention in China’s stock market include 10 percent daily price move limits, short-sale restrictions, trading suspensions, IPO suspensions, and the deployment of a “national team” of securities brokerages to buy or sell stocks and stabilize the market’s value.

Poor corporate governance standards of many Chinese issuers, which file misleading corporate financial disclosures, compound these risks and undermine efficiency in China’s financial markets as investors cannot accurately ascertain the value of securities. According to testimony from Brian McCarthy, chief strategist at investment advisory firm Macrolens, another example of this market inefficiency can be found in the wide difference between share prices for separate stocks issued by Chinese firms in Shanghai and Hong Kong, a price gap called the “A-to-H valuation premium.” On average, for companies that have dual-listed shares in Shanghai and Hong Kong, the A-shares traded in Shanghai are priced 20 percent higher than H-shares of the same company sold in Hong Kong. According to Michael Pettis, expert on China’s financial markets, this persistent valuation gap is likely attributable to bouts of speculative investing in which exuberant and inexperienced Chinese retail investors buy stocks based on government signaling and stated...
The finding suggests pricing of onshore Chinese equities may be informed more by political undercurrents than market fundamentals.

In testimony before the Commission, witnesses debated whether the risks present in China’s financial markets are unique to China or are also visible in other emerging markets. According to Gabriel Wildau, senior vice president at Teneo Holdings, the risks associated with investing in China are typical of emerging market risks generally. He also noted those who trade in Chinese and other emerging markets are usually sophisticated individual or institutional investors with sufficient trading experience and expertise to anticipate and mitigate emerging market risks. Some investors and pension funds in the United States, however, are likely to be increasingly exposed to these risks as their investments are placed in funds that replicate investment indices, which include Chinese securities. Additionally, as Mr. McCarthy observed, other emerging markets do not possess the same global economic heft and expanding financial links with U.S. and global capital markets as China.

Mr. Loevinger added that foreign investors’ ability to move funds out of China may come into question should markets come under stress and regulators impose trading restrictions, as occurred in the 2015 Chinese stock market rout.

Unwitting Support for Problematic Chinese Companies

The passive investment management style associated with index funds can preclude investors from being fully aware of the constituent securities in which they are investing, raising the risk that they may unintentionally provide material support to Beijing’s industrial policy goals or problematic companies. For example, several constituent A-shares in the MSCI All Country World Index (ACWI) are subsidiaries of state-owned defense conglomerate Aviation Industry Corporation of China, which has advanced China’s military-civil fusion strategy through the acquisition of aerospace and engineering firms in the United States and Europe.

Investors may also be inadvertently supporting companies whose operations are antithetical to U.S. national security and foreign policy interests. In testimony before the Commission, Nazak Nikakhtar, assistant secretary for industry and analysis at the U.S. Department of Commerce, noted that several Chinese companies on the department’s Entity List are also included in the MSCI ACWI Index against which the Thrift Savings Plan’s (TSP) International Stock Fund (“I Fund”) is scheduled to be tracked. These companies include iFlytek, Zhejiang Dahua, and Hikvision Technology. These

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†The TSP is a retirement savings and investment plan for U.S. federal government employees and members of the uniformed services.
‡The TSP I Fund currently invests in a stock index fund that replicates the MSCI EAFE (Europe, Australasia, Far East) Index. In November 2017, the Federal Retirement Thrift Investment Board (FRTIB), which administers the TSP, decided to replace the MSCI EAFE Index benchmark with the MSCI ACWI Index benchmark at a future date. On May 13, 2020, the FRTIB announced it would defer action on the I Fund transition to the MSCI ACWI Index indefinitely at the urging of the Trump Administration. Federal Retirement Thrift Investment Board, “Federal Retirement Thrift Investment Board Defers Action on I Fund Transition,” May 13, 2020.
electronics and software firms were placed on the department’s Entity List in October 2019 because they supplied surveillance technology deployed in Beijing’s repressive campaign of mass detention and surveillance of Muslim minority groups.137 A-shares of these same firms are also included in the FTSE Global Equity Index Series (GEIS).138

The placement of selected Chinese firms on the Entity List has not prevented their inclusion in investment indices, which are lightly regulated. In a briefing to the Commission, staff from the U.S. Securities and Exchange Commission (SEC) noted that while the SEC has no statutory authority over index providers, it does require investment funds that track indices to disclose principal risks related to investments that comprise the index,† which may include risks related to valuation, liquidity, and political risks.139 In testimony to the Commission, Dr. Scissors warned such lack of oversight undermines simultaneous U.S. policy objectives to defend against unfair economic practices of China’s state-supported firms.140

Selected Risks and U.S. Policy Concerns Associated with U.S.-Listed Chinese Companies

Opaque Ownership

In addition to index inclusions, many Chinese firms choose to raise capital from foreign investors directly by issuing stock on foreign exchanges, particularly in the United States. As of October 2, 2020, there were 217 Chinese companies listed on the three largest U.S. exchanges‡ with a total market capitalization of $2.2 trillion.141 The murky ownership of these firms, together with their noncompliance

*Though the International Organization of Securities Commissions, an international body that convenes global securities regulators to develop and implement standards for securities regulation, published guidelines in 2013 on appropriate disclosure of investment index construction methodologies, these guidelines are not legally binding. This dynamic has led some experts to argue that “index providers have become actors that exercise growing private authority as they steer investment through the indices they create and maintain.” The U.S. Securities and Exchange Commission does not regulate the content of stock market indices. Johannes Petry et al., “Steering Capital: The Growing Private Authority of Index Providers in the Age of Passive Asset Management,” Review of International Political Economy, December 10, 2019, 19; International Organization of Securities Commissions, “Principles for Financial Benchmarks,” July 2013; U.S. Securities and Exchange Commission, Market Indices, updated October 15, 2012.

†Language in such disclosures is standardized and may not sufficiently specify the risks unique to Chinese securities and those from other emerging markets featured in the index-tracking fund. For example, KraneShares, which provides a suite of China-focused exchange traded funds (ETFs) to investors, offers a “KraneShares MSCI All China Index ETF” that tracks the price performance of the MSCI China All Shares Index. In its risk disclosure for the ETF, KraneShares states that “[i]nvesting involves risk, including possible loss of principal. There can be no assurance that a Fund will achieve its stated objectives. The Funds are subject to political, social or economic instability within China which may cause decline in value. Fluctuations in currency of foreign countries may have an adverse effect to domestic currency values. Emerging markets involve heightened risk related to the same factors as well as increase volatility and lower trading volume.” Separately, emerging market investment firm Seafarer Funds offers a “Seafarer Overseas Value Fund,” an ETF that tracks the MSCI Emerging Markets Total Return Index. Its risk disclosure states that “[a]n investment in the Funds involves risk, including possible loss of principal. International investing involves additional risks, including social and political instability, market and currency volatility, market illiquidity, and reduced regulation. Emerging markets are generally more volatile than developed markets, and investing in emerging markets involves greater risks. Fixed income investments are subject to additional risks, including but not limited to interest rate, credit, and inflation risks. Value investments are subject to the risk that their intrinsic value may not be recognized by the broad market. An investment in the Funds should be considered a long-term investment.” KraneShares, “KraneShares MSCI All China Index ETF Fact Sheet,” September 30, 2020, https://kraneshares.com/resources/factsheet/2020_09_30_kall_factsheet.pdf; Seafarer Funds, “Seafarer Overseas Value Fund,” June 30, 2020. https://www.seafarerfunds.com/documents/osl-factsheet.pdf.

‡The three largest exchanges include the Nasdaq, New York Stock Exchange (NYSE), and NYSE American (formerly the American Stock Exchange, or AMEX).
with disclosure standards governing U.S. capital markets and U.S. regulators’ impeded oversight of them, create an array of political, regulatory, and economic risks for U.S. investors.

Concerns regarding opaque ownership are further heightened by some Chinese companies’ use of a complex variable interest entity (VIE) structure* to list in the United States. U.S.-listed Chinese firms most attractive to investors operate in high-growth sectors such as e-commerce and telecommunications. Because these sectors are deemed sensitive by the Chinese government, direct foreign ownership in them is restricted. Chinese firms thus use VIE structures to circumnavigate these restrictions and raise capital in overseas financial markets. These structures create effective foreign ownership of the company through an abstract mix of legal contracts and equity ownership while still loosely complying with Chinese foreign ownership laws. Investors’ attempts to enforce contractual arrangements or seek redress often fail for two primary reasons: (1) U.S. regulators lack jurisdiction over the locations where Chinese companies utilizing a VIE structure tend to be domiciled and (2) Chinese regulators do not recognize the legality of the VIE structure.142

**Insufficient Disclosure and Oversight Challenges**

The SEC and Public Company Accounting Oversight Board (PCAOB)† oversee disclosures, reporting, and audits of public companies listed on U.S. exchanges. U.S.-listed Chinese companies pose unique challenges to this oversight. Specifically, Chinese authorities block the PCAOB from reviewing the audits of U.S.-listed Chinese companies on national security grounds.143 Despite nearly a decade‡ of negotiations with their Chinese counterparts, the SEC and PCAOB issued a joint statement in April 2020 affirming that the issue remains unresolved.144 In the statement, the regulators warned that investors should consider the risks associated with lack of PCAOB access to audit reports and added that issuers should clearly disclose such risks to investors.145 Article 177 of China’s updated Securities Law also stipulates that overseas audit regulators are not allowed to conduct investigations within China.146

An example of the problems arising from the PCAOB’s lack of visibility into U.S.-listed Chinese companies’ financial statements is the case of Luckin Coffee, formerly listed on Nasdaq. Luckin Coffee’s IPO on Nasdaq in May 2019 raised $650 million, and the company’s market value peaked at $12 billion in January 2020 following the sale of another $865 million of stock and debt.147 On April 2, 2020, the company announced its chief operating officer had fabricated

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†The PCAOB is a private nonprofit organization created by the Sarbanes-Oxley Act of 2002 to oversee the audits of public companies. It is overseen by the SEC.

‡The SEC, PCAOB, China’s Ministry of Finance, and the CSRC began to discuss joint inspections of accountancies undertaking audits for U.S.-listed Chinese companies in 2011. These discussions resulted in a Memorandum of Understanding on enforcement cooperation in 2013, though the PCAOB maintains that Chinese audit regulators’ cooperation remains insufficient for the agency to obtain timely access to relevant documents and testimony necessary to inspect the audit papers of U.S.-listed Chinese firms. Reuters, “Timeline: U.S., HK Regulators Struggle to Get China Audit Papers,” December 20, 2017; Public Company Accounting Oversight Board, “China-Related Access Challenges.”
approximately $310 million in sales in 2019. The Luckin Coffee scandal epitomized other deficiencies concerning to the SEC and PCAOB, such as the reporting of low-quality financial information. For example, the company historically reported “store level operating profit” in its financial statements, an alternative earnings measure that ignores firm-level operating costs and therefore obfuscates accurate assessments of cash balances.

The Luckin Coffee episode highlights shortcomings in U.S. law vis-à-vis U.S.-listed Chinese companies. These companies, like all other foreign private issuers (FPIs), are exempt from the higher disclosure and reporting requirements otherwise imposed on domestic issuers. For example, FPIs are exempt from Regulation Fair Disclosure (a rule the SEC adopted in 2000 to stop selective disclosure that can lead to insider trading) and are not required to file audited quarterly reports with the SEC. The COVID-19 outbreak may reveal other instances of substandard accounting and dubious financing as funding markets tighten. In April 2020, for example, independent financial analysts alleged that video streaming firm iQiyi had inflated its 2019 revenue, leading the SEC to open an investigation into the matter in August.

**U.S. Tightens Scrutiny of Chinese Securities**

In 2020, the Trump Administration and Congress took preliminary steps to close regulatory loopholes and curtail the flow of financing to Chinese entities whose operations threaten U.S. policy interests. On May 12, 2020, the Trump Administration directed the Federal Retirement Thrift Investment Board to “immediately halt” steps to benchmark the TSP’s I Fund to the MSCI ACWI Index. While the Administration’s directive will affect U.S. federal employees’ retirement accounts, U.S. investment dollars will continue flowing into Chinese assets through other avenues. An array of U.S. private companies’ and federal government contractors’ defined contribution retirement plans, for example, currently track the MSCI ACWI Index, as do the public employee pension systems for the states of California, Florida, New York, North Carolina, Ohio, and Washington. Experts estimate that all U.S. investors may hold just 2 percent of Chinese stock markets’ total market capitalization. Therefore, the restriction of U.S. portfolio investment flows to Chinese companies, whether through public or private sector pension plans, may not meaningfully impact these companies’ overall financial position or alter their conduct.

Separately, on July 24, the Presidential Working Group on Financial Markets released its Report on Protecting United States Investors from Significant Risks from Chinese Companies. The report’s release followed the unanimous passage in the Senate of the S. 945

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* FPIs must still file audited annual reports with the SEC.
† The Presidential Working Group on Financial Markets was originally established by an executive order issued by then President Ronald Reagan with the mandate of investigating the causes of the 1987 stock market crash. It is chaired by the Treasury secretary and includes the chairman of the board of governors of the Federal Reserve System, chairman of the SEC, chairman of the Commodity Futures Trading Commission, or their designees. On June 4, 2020, President Donald Trump directed the group to prepare a report within 60 days detailing recommended approaches to protect U.S. investors from the poor accounting standards of U.S.-listed Chinese companies and other risks. White House, Memorandum on Protecting United States Investors from Significant Risks from Chinese Companies, June 4, 2020; National Archives, Executive Order 12631—Working Group on Financial Markets, March 18, 1988.
Holding Foreign Companies Accountable Act on May 20.* The report’s top recommendation would prohibit Chinese companies from listing on U.S. exchanges after 2022 if their auditors cannot be inspected by the PCAOB, while auditors of new IPOs on U.S. exchanges must be inspectable immediately.† Alternatively, U.S.-listed Chinese companies could provide a “co-audit” from an accounting firm whose records can be inspected by the PCAOB. Under such an approach, a U.S.-based accounting firm could inspect a Chinese company’s financial statements alongside the audit performed by its Chinese affiliate. This would theoretically enable the PCAOB to have access to the work papers of the U.S. accounting firm performing the co-audit.160

While Treasury Secretary Steven Mnuchin stated in August that this recommendation would be adopted by the SEC, the new rulemaking it requires suggests implementation may take time.‡ Questions also remain around the circumstances under which Chinese audit regulators would allow access to audit work papers, something they have historically denied. China’s updated Securities Law also expressly forbids Chinese citizens and companies from complying with overseas securities regulations without the permission of Chinese authorities.161 Following the report’s release, the CSRC called for “dialogue” on the issue of co-audit arrangements, suggesting a resolution to the PCAOB’s inability to access U.S.-listed Chinese companies’ audit work papers will remain elusive.162

The Chinese government took steps in 2020 to encourage Chinese companies listed overseas to issue shares in mainland stock markets as Washington stepped up oversight of Chinese securities. In May, for example, the CSRC lowered the market value threshold for Chinese companies listed overseas to issue shares at home from $28.2 billion (RMB 200 billion) to $2.8 billion (RMB 20 billion).§

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*The S. 945 Holding Foreign Companies Accountable Act would require foreign companies to be delisted from U.S. exchanges if the PCAOB has been unable to review their audit work papers for three consecutive years, effectively putting Beijing on a timeline to remove the obstruction on the review of audits conducted by accounting firms in China. It would also require U.S.-listed Chinese companies to disclose CCP affiliations of any company executives and whether their articles of incorporation contain any charter of the CCP. Recommendations proposed in the Presidential Working Group on Financial Markets report do not include such provisions regarding the reporting of CCP affiliations. Alexandra Alper, “Trump Advisers Urge Delisting of U.S.-listed Chinese Firms That Fail to Meet Audit Standards,” Reuters, August 6, 2020; U.S. Department of the Treasury, President’s Working Group on Financial Markets: Report on Protecting U.S. Investors from Significant Risks from Chinese Companies, July 24, 2020, 3; Holding Foreign Companies Accountable Act, S. 945, May 20, 2020.

†The recommendation is modeled on one of the U.S.-China Economic and Security Review Commission’s 2019 recommendations that Congress enact legislation to preclude Chinese companies from issuing securities on U.S. stock exchanges if the PCAOB is denied timely access to the audit work papers relating to the company’s operations in China; the company’s disclosure procedures are not consistent with best practices on U.S. and European exchanges; the company utilizes a VIE structure; and the company does not comply with Regulation Fair Disclosure, which requires material information to be released to all investors at the same time. See U.S.-China Economic and Security Review Commission, Chapter 3, Section 1, “U.S.-China Commercial Relations,” in 2019 Annual Report to Congress.

‡The proposed measures would require the SEC and U.S. exchanges to engage in lengthy rulemaking processes before taking effect. U.S. exchanges would first need to draft a proposed rule incorporating the SEC’s new listing standards. The proposed rule would then need to be reviewed and approved by the SEC before being published in the Federal Register. U.S. law requires the SEC to act on the proposed change in 45 days following publication in the Federal Register, or up to 90 days if deemed appropriate. Paul Gillis, “President’s Working Group,” China Accounting Blog, August 10, 2020; Demetri Sevastopulo and Kadim Shubber, “Trump Team Outlines Plan to Crack Down on U.S.-Listed Chinese Groups,” Financial Times, August 7, 2020.

jing also pushed domestic companies seeking to raise capital abroad to consider markets besides the United States. In mid-May, Reuters cited anonymous sources in reporting that the Chinese government resumed its review of applications from companies seeking to sell global depositary receipts in London via the London Shanghai Stock Connect program.* In 2020, U.S.-listed Chinese companies also looked to issue shares in Hong Kong to lessen risks and broaden their investor base. For example, Baidu, NetEase, and JD.com, all currently listed in the United States, made moves to list in Hong Kong in June.\textsuperscript{165}

### U.S. Regulatory Process for Delisting Foreign Issuers

The Sarbanes-Oxley Act of 2002 empowers the SEC to delist a company that does not comply with auditor inspection requirements set forth by the PCAOB. If registered auditors do not comply with PCOAB rules, the board can take disciplinary or remedial actions,\textsuperscript{†} including the temporary suspension or permanent revocation of the auditor's registration.\textsuperscript{166} In a December 2018 joint statement, the chairmen of the PCAOB and SEC stated that the failure of China-based auditors to allow the inspections could subject those firms to such measures.\textsuperscript{167}

The PCAOB’s deregistration of an auditor could result in the delisting of foreign issuers using that auditor if they do not have their financial statements audited by a registered accounting firm during the subsequent reporting period. Specifically, SEC rules require that issuers submit regular financial statements audited by a PCAOB-registered accounting firm or risk having their financials deemed “not audited,” which results in a designation of “substantially deficient” on their 10-K (or 20-F for foreign issuers) filing.\textsuperscript{‡} These determinations could result in a number of SEC


\textsuperscript{†To} date, the PCAOB has refrained from acting against China-based auditors who do not allow the board to inspect their audit work. The only action has come from the SEC, when in 2012 it filed a lawsuit against five Chinese accounting firms (mostly China affiliates of the major “big four” accounting firms, Deloitte, KPMG, EY, and PricewaterhouseCoopers) for refusing to hand over documents connected to investigations of wrongdoing by Chinese companies. One reason for the PCAOB’s reticence may be that a number of U.S. multinationals with significant operations in China use Chinese affiliates of the big four accounting firms to conduct their audits, and the PCAOB seeks to avoid harming these firms. Paul Gillis, written testimony for U.S.-China Economic and Security Review Commission, Hearing on Risks, Rewards, and Results: U.S. Companies in China and Chinese Companies in the United States, February 28, 2019, 10; Michael Rapoport, “The Chinese Blind Spot in U.S. Companies Financials,” Wall Street Journal, July 21, 2018; U.S. Securities Exchange Commission, SEC Charges China Affiliates of Big Four Accounting Firms with Violating U.S. Securities Laws in Refusing to Produce Documents, December 3, 2012.

\textsuperscript{‡This} determination would affect all companies using the deregistered auditor, including U.S. companies with some operations in China audited by the Chinese auditor. Whether the deregistration of a Chinese auditor by the PCAOB would impact U.S. multinationals’ regulatory compliance depends on the extent to which Chinese auditors contribute to the production of their audit reports. For example, EY conducted General Motors Company’s 2018 audit, and its China
staff actions, including suspension of trading or revocation of the
registration of companies that submit deficient financial reports.
Therefore, if a Chinese firm's auditor were deregistered by the
PCAOB, its next submission of audited financials would be non-
compliant with both SEC rules and, by extension, the rules of the
exchange on which it is listed, which makes the corresponding
determination.* To delist the company, the listing exchange would
submit Form 25 to the SEC. Ten days following the submission of
Form 25, the exchange can strike the company's securities from
its listings, and 90 days after the filing the SEC would deregister
the company (see Figure 7). 169

Figure 7: U.S. Regulatory Process for Delisting Foreign Issuers

Once the SEC and relevant listing exchange have respectively
deregistered a company's auditor and delisted its securities, those
securities would remain legally owned by investors and tradable

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* U.S. exchanges themselves are regulated by the SEC's Division of Trading and Markets.

Source: Created by Commission staff.

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affiliate, Ernst and Young Hua Ming LLP (“Hua Ming”), contributed between 5 percent and 10
percent of the firm’s fees and engagement hours. As a result, unless Hua Ming performed the
majority of audit work for one of General Motors’ China-based subsidiaries, which itself accounts
for 20 percent of General Motors’ total assets or revenues, General Motors would remain compli-
ant with U.S. regulations even if the PCAOB moved to deregister Hua Ming. China accounting
expert and frequent commentator Paul Gillis adds that if the PCAOB were to deregister Chinese
auditors, the impact on U.S. multinationals would be limited to a handful of companies whose
operations are primarily based in China. Paul Gillis, written testimony for U.S.-China Economic
and Security Review Commission, *Hearing on Risks, Rewards, and Results: U.S. Companies in
China and Chinese Companies in the United States*, February 28, 2019, 10; Ernst and Young
LLP, “General Motors Company Form AP,” February 22, 2019, retrieved from Public Company
Accounting Oversight Board.
Implications for the United States

The U.S. government is moving to confront China’s unfair economic policies and threats to national security and values. At the same time, U.S. investment ties with China are deepening, with hundreds of billions of U.S. investment dollars flowing to Chinese companies that threaten U.S. policy interests, commit fraud, already receive state support, and respond to nonmarket incentives. The Chinese government is strategically opening its financial sector to secure more of these capital inflows, leading global investment index providers to include a growing number of Chinese securities in their indices. As a result, individual U.S. savers are increasingly likely to own Chinese equities, hold China’s sovereign debt in their portfolio, or acquire Chinese NPLs. For the moment, U.S. portfolio inflows into China remain relatively small but are poised to grow significantly, especially if China’s economy recovers from the COVID-19 outbreak before the United States and other major economies, making Chinese capital markets more attractive. U.S. investors are also exposed to China’s financial assets within U.S. capital markets, with 217 Chinese companies issuing stock directly on U.S. stock exchanges. This rising exposure to China’s financial markets poses an array of implications for the United States.

**Risks to U.S. Investors:** Rising exposure to China’s financial system presents unique and significant risks to U.S. investors, savers, and retirees. Because of the opacity surrounding Chinese companies’ ownership, operations, and political ties, it is often difficult to ascertain their financial health. In many cases, these companies’ actions may also be motivated by nonmarket considerations that conflict with their fiduciary duty to U.S. shareholders. The Chinese government’s ability to reach in and control any company’s actions, regardless of ownership, creates unavoidable political risk for U.S. investors. Moreover, Beijing’s frequent intervention into capital markets and manipulation of market forces to ensure economic stability poses additional regulatory risk. These hazards extend to U.S. capital markets as well. As the recent Luckin Coffee scandal and numerous other past examples demonstrate, the PCAOB’s continuing lack of access to Chinese companies’ audit papers exposes investors in

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the U.S. stock market to potential fraud with little legal recourse to recover losses. The continued inability of the PCAOB to inspect the audit records of U.S.-listed Chinese companies erodes the integrity of U.S. capital markets.

**U.S. Foreign Policy Interests:** As a strategic competitor to the United States, Beijing’s distortive economic practices, disregard for human rights, and rapid military buildup harms U.S. policy interests. Increased U.S. participation in China’s financial markets raises the possibility that U.S. investors are inadvertently financing actions the United States otherwise seeks to mitigate and defend against. For example, the MSCI ACWI includes A-shares of several subsidiaries of Chinese state-owned defense conglomerate Aviation Industry Corporation of China, which supports China’s military-civil fusion strategy, as well as companies that have supplied surveillance technology used in the repression of Muslim minority groups in Xinjiang. Separately, state-owned bank ICBC, which was directed by Beijing to shore up the Bank of Jinzhou, is included in the FTSE GEIS. Still other companies included in these indices already receive hefty state support, enabling them to unfairly outcompete U.S. companies. Increased U.S. investment flows to such companies further distorts the playing field between U.S. firms and their Chinese competitors. There are also gaps in existing U.S. regulations that allow for money to flow to companies that have been found to be in violation of U.S. laws. For example, the inclusion of companies such as iFlytek and Hikvision—currently subject to U.S. export restrictions—into indices widely tracked by U.S. investment funds amounts to one set of rules for exports and another contradictory set of rules for investment.

**U.S. Business Interests:** Though Beijing is moving to liberalize China’s financial sector, its steps are incremental and designed to serve state objectives. For example, Beijing has implemented financial opening commitments outlined in the Phase One agreement on an uneven basis and, in a repeat of past practice, appears poised to empower state-owned banks in an effort to limit new U.S. and other foreign financial firms’ participation in China’s financial markets. Such actions follow a familiar pattern whereby the Chinese government first welcomes foreign investment in newly opened sectors and then unfairly strengthens domestic firms’ ability to compete with foreign firms. Beijing’s pursuit of financial opening also seeks to resolve immediate economic difficulties. The entry of U.S. distressed asset investors into China following the Phase One agreement, for example, enables Beijing to exploit foreign capital in cleaning up China’s heavily indebted financial system. This pattern of calibrated opening underscores how economic liberalization in China occurs only on Beijing’s terms and in service of domestic priorities. Against this backdrop, U.S. financial services firms may never be able to compete on the same basis as their state-backed Chinese competitors.

There is every indication that China’s quest for capital will continue. The Chinese government is drawing in foreign money to address persistent and worsening problems ailing its financial system. Local governments shoulder crushing debt and face revenue shortfalls. Banks are undercapitalized and NPLs are on the rise. The economi-
ic impact of COVID-19 threatens to erode the financial position of China’s vibrant ecosystem of small, private businesses, which were already credit starved before the pandemic. China has experienced persistent capital outflows since 2014, and increased household and public expenditure on caring for an aging population will erode national savings and push China to attract more funds from overseas to finance its needs. As the Chinese government increasingly turns to foreign investment to shore up its domestic financial system, this could pose risks to a wide range of U.S. stakeholders, raising doubts about whether deeper integration of the U.S. and Chinese financial systems is desirable.
Addendum I: Chinese Government Interventions into Financially Distressed Banks, 2019–2020

<table>
<thead>
<tr>
<th>Bank Name</th>
<th>Type of State Intervention</th>
<th>Description</th>
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<tbody>
<tr>
<td>Baoshang Bank</td>
<td>Government receivership</td>
<td>In May 2019, the CBIRC took over direct control of Baoshang Bank through a one-year government receivership. The PBOC’s announcement of the takeover cited the bank’s “serious credit risk” as a justification. Although the PBOC guaranteed deposits and interbank liabilities up to $7.1 million (RMB 50 million), it forced Baoshang’s larger creditors to accept losses of up to 30 percent.</td>
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<tr>
<td>Bank of Jilin</td>
<td>Private placement to local government finance departments</td>
<td>In July 2019, the CSRC approved the Bank of Jilin’s application for a private placement to the Jilin Provincial Finance Department, Liaoyuan City Finance Bureau, and the Baishan City Finance Bureau. In November 2019, authorities announced that the bank’s former chairman was under investigation for graft.</td>
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<tr>
<td>Bank of Jinzhou</td>
<td>Share purchase by national state-owned companies and private share placement</td>
<td>In July 2019, ICBC and two national state-owned AMCs announced they would acquire strategic stakes of between 17 and 25 percent in the Bank of Jinzhou. Two months later, the bank announced it would seek to raise $866 million to rebuild its capital base. In March 2020, the bank announced it would conduct a private share issue to two state-owned companies, raising an additional $1.7 billion for capital replenishment.</td>
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<tr>
<td>Hengfeng Bank</td>
<td>Private placement to national and local state-owned companies</td>
<td>In August 2019, Shanghai Securities News reported that state-owned Central Huijin Investment, an arm of China’s sovereign wealth fund, would make a strategic investment in Hengfeng Bank. In December 2019, Caixin reported that the bank would raise $14.2 billion through a private placement that gives Central Huijin Investment a 54 percent stake and a second buyer, Shandong Financial Asset Management Co., a 32.4 percent stake. The bank’s former chairman, Jiang Xiyun, was sentenced to death for graft in December 2019.</td>
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<tr>
<td>Harbin Bank</td>
<td>Share purchase by local state-owned companies</td>
<td>In November 2019, two provincial state-owned companies, Harbin Economic Development and Investment Co. and Heilongjiang Financial Holdings Group Co., purchased a combined 48 percent stake in Harbin Bank from six private shareholders.</td>
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## Addendum I: Chinese Government Interventions into Financially Distressed Banks, 2019–2020—Continued

<table>
<thead>
<tr>
<th>Bank Name</th>
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<tbody>
<tr>
<td>Chengdu Rural Commercial Bank</td>
<td>Share purchase by local state-owned companies</td>
<td>In December 2019, <em>Caixin</em> reported that state-owned Chengdu Xincheng Investment Group would lead the acquisition of Anbang Insurance Group’s majority stake in Chengdu Rural Commercial Bank. News that Anbang’s stake was for sale followed an announcement that the bank’s former chairman was under investigation for graft. The sale was completed in March 2020.</td>
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<tr>
<td>Bank of Gansu</td>
<td>Private placement to existing shareholders</td>
<td>In April 2020, <em>Caixin</em> reported that the Gansu provincial government approved a bailout plan for Bank of Gansu through a private share issue. According to the report, the plan also involved special loans from the PBOC and would help the bank offload $1.4 billion in nonperforming assets. Ten days earlier, the bank’s share price dropped 43.48 percent in a single day after the bank reported an 85.2 percent drop in profits in 2019.</td>
</tr>
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</table>

*Source: Various.*

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Addendum II: Global Investment Index Providers’ Inclusion Schedules for Chinese Securities

- **MSCI:** In June 2017, U.S. investment research firm and index provider MSCI announced it would begin including A-shares in its benchmark Emerging Market (EM) Index and All Country World Index (ACWI).\(^{174}\) The initial inclusion took place in May 2018 and added 230 large cap* A-shares at an inclusion factor\(^\dagger\) of 2.5 percent.\(^{175}\) MSCI raised its inclusion factor gradually in a multistage process to its current inclusion factor of 20 percent.\(^{176}\) As of November 2019, 472 China A-shares represent 4 percent of MSCI’s EM Index and 0.5 percent of its ACWI.\(^{177}\) Applying these weightings to total assets under management currently benchmarked against the two indices generates a projection of $60 billion and $16 billion in inflows, respectively.\(^{178}\)

- **FTSE Russell (equities):** In September 2018, London Stock Exchange subsidiary and indexing services company FTSE Russell announced it would promote China A-shares to “secondary emerging market status,”\(^\ddagger\) a change that made them eligible for inclusion in FTSE Russell’s benchmark GEIS.\(^{179}\) FTSE Russell simultaneously announced plans for an A-shares inclusion in four tranches from June 2019 to June 2020, though the March 2020 inclusion was reduced with outstanding inclusions delayed until June 2020 in light of “implementation risk.”\(^{180}\) Similar to MSCI’s phased weighting expansion, each tranche raises the inclusion factor (with the four tranches set at 5 percent, 15 percent, 17.5 percent, and 25 percent, respectively) and increases the number of securities included.\(^{181}\) FTSE Russell’s indices already include a broader set of Chinese equities (1,093 distinct securities as of September 2019) than MSCI because they do not restrict inclusions by size, whereas MSCI only includes large cap and mid cap equities.\(^{182}\)

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\*Large cap, mid cap, and small cap are commonly used classifications that refer to the size of listed companies measured by market capitalization (the number of outstanding shares multiplied by the share price). Although in the United States $10 billion is the typical threshold for a company to be considered large cap, private financial institutions will sometimes use their own definitions. MSCI frequently adjusts its minimum thresholds for classifying securities as small, mid, or large cap, but as of April 2018 it applied a cutoff of $8.6 billion for the large cap classification in emerging markets. Tom Gresham, “What Is the Difference between Large Cap & Small Cap Stocks?” Zacks, April 25, 2019; MSCI, “MSCI Global Investable Market Indexes Methodology,” May 2018, 21. [https://www.msci.com/eqb/methodology/meth_docs/MSCI_GIMIMethodology_May2018.pdf](https://www.msci.com/eqb/methodology/meth_docs/MSCI_GIMIMethodology_May2018.pdf)

\dagger The assigned weighting of a security or group of securities within an equities index is in part determined by an “inclusion factor,” defined as the proportion of total investable market capitalization included in the index. In the Chinese context, market capitalization is adjusted to account for foreign ownership restrictions. Although the inclusion factor is expressed as a percentage, this should not be confused with the security’s weighting within an index (also expressed as a percentage). In other words, an inclusion factor of 20 percent indicates that 20 percent of the relevant security’s market capitalization is used for index construction; it does not mean the security will have a 20 percent weighting within the index. FTSE Russell, “China A-Shares Inclusion—Seven Key Points,” June 24, 2019; MSCI, “China A-Shares Inclusion: Implementation Q&A,” July 2018. 6. [https://www.msci.com/documents/1296102/1330218/CNA_Incl_QA.pdf/acc8b584-cccc-4483-958f-f2558d8db1a](https://www.msci.com/documents/1296102/1330218/CNA_Incl_QA.pdf/acc8b584-cccc-4483-958f-f2558d8db1a).

• **Bloomberg:** In March 2018, Bloomberg announced it would include RMB-denominated sovereign and policy bank bonds in its Bloomberg Barclays Global Aggregate Index. The inclusion schedule is phased over a 20-month period that began in April 2019. It is expected to result in a 6 percent weighting of Chinese securities within the index with associated projected inflows of $150 billion.

• **JPMorgan:** JPMorgan initiated a ten-month process of adding Chinese government bonds to its Government Bond Index-Emerging Markets (GBI-EM) series in late February 2020 with the view of eventually giving China a 10 percent weight in its Global Diversified Index tracked by funds with an estimated $202 billion under management. The COVID-19 outbreak in China delayed these plans, with the firm announcing it would keep China’s weight at 1 percent at the end of March and re-assess the inclusion schedule at a later date. JPMorgan estimates that the inclusion of Chinese securities into its GBI-EM index series will lead to inflows of between $22 billion and $24 billion.

• **FTSE Russell (fixed income):** In September 2020, FTSE Russell announced it would add Chinese government bonds to its World Government Bond Index (WGBI). The inclusion schedule is expected to be phased over a 12-month period beginning in October 2021. Analysts anticipate that the inclusion of Chinese government bonds into the FTSE Russell WGBI could lead to $100–$140 billion in potential foreign inflows into Chinese government debt.
ENDNOTES FOR SECTION 2


68. People’s Bank of China via CEIC database.


114. He Huifeng, “Xi Jinping Promises to Open China’s Door Wider for Foreign Investors,” South China Morning Post, April 10, 2018; Kevin Yao, “China Pledges to Allow More Foreign Investment in Financial Sector by Year-End,” Reuters, April 10, 2018.


