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Hearing on “China’s Quest for Capital: Motivations, Methods, and Implications”

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Summary

- Due to China's high national savings rate, the country is financially self-sufficient on a macro level. Specific companies choose to seek financing abroad for particular reasons, of which policy arbitrage is the most important.
- This fact means that cutting off US investment in Chinese companies would be unlikely to inflict macro-level damage on the Chinese economy, even though particular companies would suffer.
- US investors have actively sought greater access to Chinese capital markets for the last 20 years. Unilaterally restricting US access to these markets now that they are largely open would mark a dramatic policy reversal.
- Chinese companies seek foreign financing when Chinese monetary policy and financial regulation leaves them unable to obtain enough financing domestically. Far from being "national champions", Chinese companies that seek US listings typically do so because they lack political and policy support within China.
- The financial and ethical risks that US investors face in China are not qualitatively different from those of other emerging markets.
- Emerging market investors are highly sophisticated and skilled at assessing risk. "Investor protection" is not a persuasive rationale for restricting US investment in Chinese companies.
- Recent decisions by securities index providers such as MSCI and Bloomberg to add domestic Chinese stocks and bonds to widely-tracked emerging market indexes appear to be motivated by Chinese reforms that removed barriers to buying and selling. These decisions do not appear to be the result of Chinese government coercion or pressure.
- In addressing ethical risks related to certain Chinese companies' involvement in human rights abuses, policymakers should take a case-by-case approach rather than banning US investment into entire markets.
- Standards should be applied consistently across countries. If policymakers seek to protect investors from financial or ethical risks, then the entire global investment landscape — not just China — should be examined systematically.

1. **China is Financially Self-Sufficient**

China's savings rate is by far the highest among the world's ten largest economies and is among the highest anywhere in the world. From a macro perspective, therefore, China does not need foreign capital to finance its investment needs.

Indeed, one of the most striking facts about China's economy is that its despite extraordinarily high investment share of GDP, China still runs a substantial current account surplus. A current account surplus is defined as the amount by which national savings exceeds investment. Traditionally, many developing countries run current account deficits because as a developing country, they require such high levels of investment that domestic savings are insufficient. This deficit requires them to draw in capital from abroad. China is an exception: its savings rate is so high that it can finance its own high investment rate and still have savings left over to export to the rest of the world.

China's domestic savings are channeled into investment primarily through the commercial banking system. Despite some diversification in recent years, China's financial system remains bank dominated. In fact, after declining through much of the 2010s, the bank share of total domestic financing has rebounded in recent years, as a regulatory crackdown on shadow banking has restricted non-bank sources of lending and forced a significant amount of off-balance-sheet activity back onto commercial bank balance sheets. Though shadow banking is in decline, domestic capital markets — especially the domestic bond market — continues to grow in importance.

I am not going to offer further detail about the internal mechanics of China's financial system here because I do not think this detail is directly relevant to the question of what role US and other foreign investors play in the system and whether US policy changes are desirable or necessary. But I am happy to answer any questions about the domestic financial system during the question-and-answer period.

For the purposes of this hearing, the key point is that on a structural basis, China does not need foreign financial investment (foreign direct investment is a separate issue). This fact means that cutting off US investment in Chinese companies would be unlikely to inflict macro-level damage on the Chinese economy, even though certain Chinese companies would suffer.

2. **Foreigners Spent 20 years Seeking Greater Access to Chinese Capital Markets**

For roughly the last 20 years, one of the key objectives of US policy towards China was to *increase* US investors' access to China's capital markets. Yields on Chinese renminbi bonds were far higher than those available in the US and other developed markets. Though China's stock market was volatile, China's economy was growing quickly, and foreign investors wanted the freedom to invest in promising companies that were riding this wave of macro growth. Increased access to Chinese capital markets was a perennial item on the US wish list during the era of the US-China Strategic and Economic Dialogue.

For most of this period, foreign access was highly limited. In 2002, China introduced the Qualified Foreign Institutional Investor (QFII) program, which allowed foreigners to trade on the Shanghai and Shenzhen stock exchanges. But QFII was limited by investment quotas, and there were also limits on repatriating investment proceeds.

Over the last decade, Chinese regulators gradually loosened the rules on QFII. They also introduced other, more convenient channels for foreign investment. The most important of these were the Shanghai-Hong Kong Stock Connect, Shenzhen-Hong Kong Stock Connect, the Hong Kong Bond Connect, and the China Interbank Bond Market scheme. Rules for this latter set of programs have also been gradually loosened to streamline access, expand eligibility, increase quotas, enable hedging of various types of risk, and resolve technical issues related to clearing, settlement, and legal custody.

The result of this long series of incremental opening measures is that today, foreign investors enjoy largely unfettered access to Chinese capital markets. Some restrictions and red tape remain, but the situation is vastly different from ten years ago. Today, investors decide whether to invest in China's onshore market largely based on their assessment of the underlying market opportunity, rather than concerns about market entry and exit barriers.

Chinese policymakers opened their financial markets primarily because they believed that doing so was in China's national interest, but foreign pressure also played a role. If the US policy were to take unilateral action to restricting US investors' freedom to access the Chinese market, this approach would mark an extraordinary and dramatic reversal of US policy. After years of banging on the door to Chinese capital markets, that door was finally opened. To adopt restrictions now would amount to slamming that door in our own faces.

In a sign of foreign demand for Chinese financial assets and the impact of China's opening measures, total foreign ownership of such assets nearly doubled between the end of 2016 and end-September 2019, reaching Rmb586bn, according to central bank data. Stocks and bonds account for about two thirds of this total, while loans and bank deposits make up the rest.

3. Why Chinese companies Choose Foreign Finance

As discussed in section 1, China is financially self-sufficient at the macro level, but certain companies still seek financing abroad. There are four main reasons that Chinese companies seek foreign financing.

i. **Regulatory and policy arbitrage.** Most Chinese banks are state-owned, and the banking system is highly regulated. Chinese banks are subject to both formal regulation as well as informal "window guidance" on how much to lend and to whom. The property sector offers a clear example. Chinese property developers are major borrowers from commercial banks, but Chinese policymakers are concerned about high housing prices and the financial risks associated with a potential housing bubble. When seeking to cool the market, regulators periodically restrict bank lending to property developers. They also periodically suspend approvals for property developers to issue domestic bonds. Not coincidentally, Chinese property developers are the largest category of issuers in Hong Kong's US dollar bond market, which is not under the direct control of mainland regulators, and also have a large presence on the Hong Kong Stock Exchange.

   Policy arbitrage is also a key factor motivating Chinese companies to list on US stock exchanges. Given the option, most Chinese companies would prefer to list in Shanghai or Shenzhen rather than the US. The reason is that valuations are usually higher on mainland exchanges than in both Hong Kong and the United States. The problem for would-be onshore issuers is that Chinese regulators maintain a tight grip on the flow of initial public offerings in Shanghai and

Shenzhen. The IPO approval process is onerous, unpredictable, and often takes years to complete. The queue of companies waiting approval has often stretched into the hundreds, though it has shortened in recent years. Regulators also exert control over the IPO price and fundraising amount.

Given the preference for domestic listings, those companies that do seek listings in the US are largely those that are unwilling or unable to navigate through China's domestic IPO process. This point is important to remember as policymakers consider restricting US listings by Chinese companies. By and large, US-listed Chinese companies are NOT Chinese national champions that enjoy strong support from the Chinese government. If they were, then they would not need to seek US listings because they would enjoy ample access to cheap financing from Chinese banks or the domestic stock and bond markets, or some combination of all three.

ii. **Foreign expansion.** Chinese companies seeking to expand abroad may choose foreign-currency financing in order to match their foreign assets with foreign liabilities. If, for example, a Chinese company seeks to build a factory in the US or to acquire a US luxury hotel, US dollar financing is a natural choice. Matching currencies eliminates foreign-exchange risk.

Some Chinese companies may pursue a foreign IPO or bond issuance — or even foreign bank borrowing — to build up their reputation among foreign investors and institutions. Doing so may help them forge relationships with potential partners, customers, national regulators, or strategic investors. A foreign financial institution that starts out buying a small tranche of US dollar bonds or US-listed stock today could become a major lender or strategic investor tomorrow.

iii. **Cost.** Some Chinese companies have ample access to domestic financing but choose foreign financing because it is cheaper. US dollar interest rates have been low since the 2008 financial crisis. As the US Federal Reserve has begun to raise interest rates while China has lowered renminbi rates, the interest-rate differential has narrowed, but dollar rates are still lower overall. This cost advantage is especially attractive during periods when Chinese borrowers expect the renminbi to appreciate or hold steady. Otherwise, renminbi depreciation can erase the cost advantage for Chinese borrowers who repay US dollar debt from renminbi revenues.

iv. **Supplementing.** Few Chinese companies rely exclusively on foreign finance. Most use foreign finance to supplement domestic sources.

4. Investment Risks in China are Similar to Other Emerging Markets

Risks of foreign investment in China include the following:

- Inadequate or misleading corporate financial disclosures.
- Uneven or arbitrary enforcement of local laws and regulations, affecting entire asset markets or specific companies.
- Government interference with corporate management or pressure on companies to pursue political or policy objectives rather than maximizing profits.

- An opaque legal system and unfair treatment of foreign litigants by Chinese courts.
- Ethical risks from investing in companies that are complicit in human rights abuses.
- Risks to a company's profitability from potential US sanctions, blacklists, or other restrictions.

None of these risks is unique to China. On the contrary, they are typical of emerging market (EM) risks generally. Indeed, central to the basic concept of EM investment is that investors accept greater risk in return for the possibility of greater returns that come from exposure to fast-growing economies. Anecdotally, I have observed that many EM investors actually cherish the opportunity to assess these risks because doing so creates the best opportunity for investors to achieve "alpha" — the term for excess returns above what a benchmark index would produce.

In a relatively transparent and efficient market like the US, alpha is difficult to achieve. The legal and regulatory environment is predictable, and relevant information is easy for all investors to obtain and analyze. These characteristics are positive for the economy overall, but they mean that individual fund managers struggle to differentiate themselves. The widespread recognition among investors that alpha is elusive in developed markets is the reason that passive investment has become so popular.

By contrast, China and other emerging markets create alpha opportunities for investors with exceptional research capabilities. To be clear, I am not talking about insider trading. There is an entire universe of investment researchers devoted to using legal but unconventional methods to understand emerging market companies. These researchers rely on language ability, understanding of local politics, local industry relationships, and journalistic-style, on-the-ground reporting to supplement the information available from corporate financial statements and government statistics.

In my years as a journalist — and more recently, as a consultant — interacting with EM investors, none ever expressed any desire for the US government to "protect" them from the risks of investment in China. These investors are highly sophisticated and confident in their ability to assess risk. Investment managers and their clients value want full freedom to take on whatever amount of risk is consistent with their investment mandate.

5. Passive investors and indexes

In recent years, major EM index companies such as MSCI and Bloomberg have altered their composition to add Chinese domestic stocks and bonds. This trend has raised concerns among policymakers that investors in passive, index-tracking funds may be exposed to Chinese risks of which they are unaware and for which they are unprepared.

I believe this concern is overstated. As mentioned in section 4, Chinese risks are not distinct from those present in other emerging markets that benchmark EM indexes have included for years. In fact, even exposure to China is not new. Any US investor who owned an exchange-traded fund (ETF) that tracked the MSCI Emerging Markets Index prior to the addition of Chinese domestic stocks was already exposed to Chinese stocks listed in the US and Hong Kong. While Chinese domestic securities may present somewhat greater risk than those traded offshore, this difference is one of degree rather than kind.

A related concern is that the Chinese government may have pressured index providers to add mainland securities, even when mainland markets do not meet the standard requirements. While I do not doubt that Chinese officials earnestly desired index inclusion and may have sought to influence the index review process, I have not seen persuasive evidence that such pressure played a significant role.

Indexers are market-driven institutions that earn profits by maintaining indexes that investors and fund managers want to track. They consult extensively with fund-manger clients before making any changes to an index. Changes that would make a given index less attractive to current or potential clients would undermine the indexers' fundamental value proposition.

As discussed in section 2, China has made significant reforms to increase foreign access to its domestic capital markets. In years past, the obstacles to index inclusion were foreign-exchange controls and other restrictions on foreign investors' ability to quickly buy and sell securities and to repatriate proceeds. In the stock market, there were particular concerns about long trading suspensions for individual stocks. Though some issues remain outstanding, these concerns have now been largely addressed. It is therefore quite plausible that substantive market reforms — rather than Chinese government pressure — are the reason for the index changes.

Nor is the prospect of business opportunities for foreign indexers in China attractive enough that such opportunities could serve as leverage to coerce indexers to sacrifice their global clients' interests. Chinese index companies dominate China's domestic market. While MSCI, Bloomberg, or other indexers may see some niche opportunities in China, I doubt they harbor any illusions that China could ever contribute more than a small slice of global revenues.

Policy recommendations

I. **Insist on full PCAOB audit access.** US and Chinese regulators are engaged in a years-long dispute over whether the Public Company Accounting Oversight Board (PCAOB) can obtain access to audit records for Chinese companies listed in the US. This dispute arises from US requirements that apply to all US-listed companies, regardless of nationality. The case for forcing Chinese companies to meet the same requirements as other US-listed companies is very strong.

II. **Address ethical risks case by case.** The US should champion human rights abroad. If the US government has compelling evidence that a particular company is complicit in human rights abuses, then sanctions that forbid US investment in that company may be appropriate. On October 28, 2019, the Commerce Department added 28 Chinese companies and government agencies to the Entity List for involvement in human rights violations in Xinjiang. The Entity List process offers a potential model for identifying foreign companies in which US investment is prohibited.

    By contrast, a broad-brush approach is not warranted. Though the Chinese government exerts significant influence over the Chinese economy and can exert pressure on specific companies, most Chinese companies are not direct or even indirect agents of Chinese influence or policy. It would be a mistake to conflate all Chinese companies with the Chinese Communist Party or the Chinese state. Thousands of Chinese companies — especially privately-owned companies, but also many state-owned companies — are commercially driven entities that seek to serve customers, earn profits, and steer clear of politics.

III. **Be clear and honest about policy objectives.** The US and China are engaged in a multi-faceted geopolitical competition that encompasses economics, technology, military power, diplomacy, ideology and culture. US policymakers could decide that US policy should aim to weaken China

along one or more of these dimensions — and that curtailing China's access to US investment would be an effective tool for doing so (though for the reasons described in section 1, I do not believe such policies would succeed in weakening China economically). Policymakers could also decide that Chinese human rights abuses are so pervasive and severe that *any* investment in *any* Chinese company makes US citizens complicit in government abuses (though for the reasons described in recommendation 2, I would disagree).

Though the wisdom and effectiveness of such policies is debatable, these rationales are at least plausible and coherent. By contrast, "investor protection" is an implausible and incoherent justification for imposing investment restrictions, for the reasons described in section 4. If policymakers insist on citing this rationale, investors in the US and around the world will quickly recognize it as a smoke screen, and US credibility will suffer. Whatever objectives we adopt, we should pursue them forthrightly and without obfuscation.

IV. **Apply standards consistently.** China is not the only country that presents financial risks to investors. China is also not the only country where the government and certain companies are involved in human rights abuses. If the goal is to protect investors from financial and/or ethical risks, then policymakers should examine the global investment landscape — not just China — to identify such risks. Investment restrictions that exclusively target China or Chinese companies would violate recommendation III above because they would rightly be viewed as unprincipled and selective.