Testimony before the U.S./China Economic and Security Review Commission

China's Quest for Capital: Motivations, Methods, and Implications

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Chairman Cleveland, Commissioner Wessel, other Commission members and staff. Thank you for the opportunity to testify on the implications of rising capital flows to China. Responding to China's rise is among the most important policy challenges of the 21st century. There are significant threats, but also opportunities. How we respond will have a material impact on our future prosperity and security. By helping to inform Congress, policy makers, and the public, the Commission continues to play a vital role.

Founded in 1971, TCW manages over $200 billion in assets for thousands of retail investors, and many of the largest corporate and public pension plans, financial institutions, endowments and foundations in the U.S. Our clients also include a number of foreign investors, including central banks and sovereign wealth funds. We employ over 600 staff in offices around the U.S. and the world. We have invested in Chinese stocks and bonds listed in markets outside of China for many years and have more recently invested in China's onshore markets. The views expressed in this testimony are strictly my own and should not be construed as reflecting TCW's.

Before coming to TCW, I had the honor of working as a non-partisan civil servant for five U.S. Presidents, Republican and Democrat, over more than two decades as well as working with you, Chairman Cleveland. This included working with Treasury Secretary Paulson to establish the U.S./China Strategic Economic Dialogue and leading Treasury's efforts in the Strategic & Economic Dialogue under Secretary Geithner.

Since then China has turned more authoritarian, with the Party's hand extending more into the affairs of private businesses. Still, I believe many of the principles that guided our China strategy remain relevant today. These include:

- While the U.S./China relationship has areas of disagreement and outright conflict it is not all zero-sum. We still share some common goals.
- As much as some in the U.S. might like, China's not going away. Addressing global challenges and advancing our interests will require finding a way to cooperate with China.
- Change in China, for better or worse, is driven by domestic politics. Don't overestimate the impact of external pressure. We should make clear our concerns over Chinese policies and bad actors. But we should not turn our fight into one against the Chinese people. Like elsewhere, Chinese leaders are boxed in by public opinion. And there are still many Chinese who share our concerns.

China's Capital Markets are Opening Up to Foreign Investment

While foreigners have bought stocks and bonds of Chinese entities for many years, China has recently taken steps to open its capital markets to foreign investors. And as a result, foreign portfolio investment has increased rapidly. In the last six years, foreign investment in in stocks issued by Chinese companies, both on and offshore, has risen more than 60% to $747 billion (as of the end of September 2019), and

investment in bonds issued by Chinese entities is up over six times during the same period, to $474 billion, but still low relative to many other major markets.

Why is China doing this? One reason is to offset dramatic changes in China's balance of payments. The years when a wall of money was gushing into China from massive "twin" current and financial account surpluses are long gone and aren't coming back. After peaking at almost 10% of GDP in 2007, China's current account surplus fell to be almost balanced in 2018 before rising slightly last year. There are many reasons for this, but an important one is China's aging population, which is drawing down household and public savings. China's accession to the World Trade Organization in 2001 unleashed a wave of inward foreign direct investment (FDI). Relative to its economy, net FDI flows are now much smaller, with incoming FDI declining and outward direct investment rising. Outward flows of portfolio investment are rising as Chinese investors seek to diversify their portfolios and reduce their underweight allocations to foreign assets. And capital flight has increased whether to evade capital controls, taxation, anti-corruption campaigns, or the rising role of the Party in private business.

Another important driver is regulators' desire to broaden, diversify, and increase the sophistication of the investor base, which remains heavily dependent on volatile retail flows, both to improve price discovery and strengthen market discipline.

Chinese officials took a number of important steps to open their markets including creating a range of channels to get through China's capital controls. Perhaps the most important was the establishment of stock and bond "connects," giving foreigners access to onshore markets through accounts set up in Hong Kong and governed by Hong Kong law.

Allowing foreign financial services firms to enter China and expand their operations, as recently codified in the Phase 1 trade deal, will further catalyze portfolio investment, though it remains to be seen whether Chinese regulators, even after foreign firms are allowed in, will take their thumb off the scale that has long favored Chinese firms. Firms like TCW are more likely to enter new markets if we can go in with our longstanding financial services partners. As fixed income investors, we are particularly pleased that China agreed to, and the Phase I deal codified, allowing foreign credit rating agencies to establish wholly-owned affiliates to rate onshore bonds. That said, it also remains to be seen whether they will be able to "call it as they see it" in an environment where information is increasingly controlled, and whether they can make a profit competing for corporate ratings against more "ratings friendly" local firms.

Inflows Are Likely to Accelerate With Inclusion, and a Rising Weight, in Major Indices

Of all the actions China has taken to open its capital markets, perhaps the most impactful one was meeting the requirements for inclusion in major equity and fixed income indices, which some analysts have equated to the financial equivalent of China's WTO accession. While shares of Chinese companies listed in Hong Kong (H-shares) have long been included in the main emerging market equity index (MSCI-EM), onshore stocks (A-shares) were included in 2018 and China's overall weight is now more than a third of the index. In fixed income, China was included last year in the Bloomberg Barclays Global Aggregate (Global Agg) Index, with their weight to rise to around 6%. Next month, China will be included in the JP Morgan Global Bond Index-Emerging Markets (GBI-EM GD), with their weight rising to the

maximum of 10%. While FTSE Russell declined in their last review to include China in the World Government Bond Index (WGBI), they are likely to do so in the next year, with a weight also around 5-6%.

Don't underestimate the power of indices. They are an increasingly powerful allocator of global portfolio flows, as more assets move to index funds, ETFs and other passive strategies, particularly in publicly traded equities. Even for some active and fixed income managers indices can have a strong gravitational pull. On a static basis (not accounting for growth in the assets that track these indices), China's inclusion in the three main indices is likely to induce around $300 billion in inflows.

Decisions over whether to include countries like China in indices and how big a weight to give them are not made by index providers alone, but rather after lengthy consultations with their clients, including asset owners and managers like TCW. There's little point in constructing indices that investors won't use, and we won't use an index that we can't effectively or efficiently track. This means we need to be able to enter and exit markets, by setting up accounts, bringing funds in and remitting them back, buying and selling both foreign currency and the constituent stock or bond, and settling trades, all without undue delay or cost (including taxation). And we need to be able to do this under a range of market conditions. There are many other factors that affect countries' inclusion and weight, including the ability to hedge exposures and undertake block trades that can be allocated to multiple accounts, as well as sanctions that restrict investors' ability to hold or trade assets.

But just because a country is included in an index, it doesn't mean that we'll automatically invest in it. Like many asset managers we work with our clients to align our investment strategies with their and their stakeholders' financial objectives and values. This includes choosing which index to use. In some cases, we'll use custom indices. Other times, we'll exclude or underweight certain assets in an index. If investors don't want to invest in China, there are plenty of indices that exclude it.

Why Foreign Investors Are Flocking to China's Markets

While China still has a long way to go in developing its capital markets, they are attractive for many reasons, including:

- Opportunity: China's stock and bond markets are the second largest in the world. Even as it slows, China's growth remains one of the highest among major economies. Many of the world's fastest growing companies are listed in China, and will be for many years.
- Volatility-adjusted yield: For a global bond investor a 3% yield on a 10-year government bond looks pretty good for a single A-rated sovereign credit in a world where 20% of investment grade sovereign bonds (in the Global Agg index) have negative yields. And if you're a dedicated emerging market investor like TCW, Chinese bonds and the Yuan have relatively low volatility compared to other bonds and currencies, making them attractive as a defensive investment.
- Diversification: While China's economy and markets are linked to the rest of the world, given its size and capacity to run counter-cyclical policies, Chinese assets are less correlated to other major markets (like the U.S. or Europe) than many other markets.

- Scale and liquidity: Given the size of Chinese markets, investors are usually able to buy and sell in large amounts, at low cost and without unduly moving market prices, particularly if they stick in fixed income markets to benchmark bonds.

China also has relatively strong credit fundamentals that we think broadly justify its single A rating. These include high growth, a diversified economy, large domestic savings, large foreign exchange reserves, and high scores in global surveys of domestic business environments (ranked 31 out of 190 countries by the World Bank and 28 out of 141 countries by the World Economic Forum).

But There Are Plenty of Risks

In our business, opportunities come with risk, and in China there are plenty, including:

- Poor policy and data transparency: Tracking China's economy is challenging due to notable gaps, particularly for national income and fiscal data. Data that are policy targets, like real GDP growth, are prone to manipulation. Despite China's significant impact on global markets, Chinese central bankers, finance ministry officials and regulators remain behind their counterparts in major emerging markets in communicating with and guiding markets.
- The lack of free expression, a free media and independent sources of information.
- Rising debt and defaults: Having undergone three credit booms in the last decade, leverage has risen notably among corporations, households, and local governments. Chinese regulators are trying to promote greater credit discipline by paring back guarantees, made all the more precarious by doing it during a cyclical downturn. Last year, even a hint that large depositors or creditors might take a haircut in Boashang Bank led to a spike in borrowing costs to other regional banks. Foreign creditors could end up with the short end of the stick in informal workouts. And recoveries from a still relatively new bankruptcy regime remain largely untested.
- Convertibility: While the ease of moving funds in and out of China was an important condition for index inclusion, the proof will be in the pudding, when markets come under stress as they inevitably do. Regulators swear they've learned lessons from the stock and currency markets debacle of 2015-16 when investors were locked into stocks when trading was official halted, even if they could theoretically get their money out. We'll see.
- Sanctions: Even with a tariff truce, tensions over technology trade and investment, foreign policy, and human rights, and financial sanctions against Chinese companies, are set to worsen.

Proposals to Restrict US Portfolio Investment in China

There have been a number of recent proposals to restrict U.S. portfolio investment in China and Chinese companies. In assessing them, it's important that policy makers consider:

What's the objective?

If you don't have a clear destination, it's hard to know if you're on the right path. Proponents of investment restrictions have cited a range of objectives from targeting specific bad actors, protecting U.S. investors, slowing China's capabilities in specific technologies, and more broadly impede China's growth and development.

How effective will the measures be?

U.S. investment restrictions are more likely to have an impact when the target is dependent on U.S. financing. For the most part, China and Chinese companies aren't. With a current account surplus, China is a net capital exporter, with domestic savings that exceed its demand for domestic investment. That doesn't mean that foreign financing doesn't matter, particularly for China's private companies that are underserved by their state dominated financial sector. It just doesn't matter much. To put it in perspective, foreign investment flows into China's bond market, for the four quarters ending in September last year, amounted to just 2% of China's credit extended to households, government agencies, and non-financial sector corporations. If you include all foreign equity flows, it amounts to about 3% of all financing (equity and credit) to these sectors. This could double or triple and it still won't amount to a hill of beans.

Moreover, this includes all foreign financing. If we go it alone, it won't even be a small mound of beans. U.S. dollar financing is the ultimate commodity. Markets are global, as are pools of savings. To the issuer there's little difference whether a dollar of financing is raised in or comes from New York, London, Hong Kong, Shanghai, Singapore, or Dubai. And it doesn't have to be dollar financing as money can be raised in other currencies. Moreover, if an investment is attractive enough for a U.S. investor, there'll be plenty of foreign investors willing to step in if we step back.

This highlights the broader challenge to the notion of financial "decoupling." Money's fungible. We can restrict U.S. investment in China but we're not going to stop investing in the rest of the world. And that will transfer resources to countries that can invest in other countries, including China.

At what cost?

Restrictions on portfolio investment would harm U.S. asset owners and managers. If we faced broad restrictions on investing in the world's second largest markets, there are plenty of foreign competitors who would be happy to serve our clients, both foreign and domestic. Many U.S. public pension funds and other asset owners already face pressure from stakeholders not to invest in a broad range of assets, while at the same time not having enough funds to meet the promises they've made to their beneficiaries. And if U.S. index providers are prohibited from including Chinese entities, or pressured to consider non-financial criteria, there are lots of foreign competitors who could provide alternatives.

Listing of Chinese companies in U.S. Markets

After the Enron accounting scandal, Congress passed the Sarbanes-Oxley law, creating the Public Company Accounting Oversight Board (PCAOB), to ensure that auditors of companies listed in U.S. markets are fit and proper. This was an important step in protecting investors. However, more than 17 years after passage, PCAOB and the SEC have yet to come to an agreement with Chinese regulators over inspections of Chinese based accounting firms (including affiliates of the major global firms) and access to internal working documents.

While my work on this issue is dated, I expect the main obstacles haven't changed much. First the U.S. has little leverage. The risk that Chinese firms won't be able to list on U.S. exchanges and would have to list either in China or other markets isn't much of a threat to Chinese regulators. It's what they want as

they work to develop their own markets. Second, not appreciating the regulatory independence of the PCAOB and SEC, I suspect that Chinese military and foreign policy hawks remain opposed to giving them access to internal accounting documents of large Chinese companies, particularly state-owned enterprises or those run by relatives of senior Party leaders.

We don't need a new law. We need existing law to be enforced. Not doing so undermines the integrity of our financial system. Chinese companies who want to list in the U.S. should play by the same rules as others, even if China's private sector and U.S. investors are the ones that ultimately get hurt if firms are delisted (To the extent U.S. investors just buy stocks in China's market instead of ours, they'll end up less protected).

As for other proposals to restrict U.S. investment in China, to have any meaningful impact actions, they should be taken in concert with other major financial centers. Restrictions only on U.S. investors will just shift business offshore and won't meaningfully limit China's access to finance. Keep index inclusion and weighting decisions based on market access. If Congress decides that investing the TSP I fund in Chinese stocks is inconsistent with U.S. interests, it has that prerogative. But don't pretend that holding back a few billion dollars will make a lick of difference. That's not even one bean. Well targeted, multilateral sanctions on specific bad actors would probably be the best way to force specific constituents out of indices.

Our Permanent Position As the Center of Global Finance Is Neither A Right Nor Foregone Conclusion

I'll end by looking longer-term, past the next election cycle. That's what responding to China's rise requires. Having the world's primary reserve currency, along with the world's most developed capital markets and asset management industry, is an extraordinary competitive advantage for the U.S., able to provide significant and low-cost financing to our most promising companies and entrepreneurs. Our currency and financial system are far superior to China's, with their financial sector still dominated by behemoth state banks.

But the dollar wasn't always the world's reserve currency and we weren't always the center of global finance. It took many decades to build and sustain this. We shouldn't be complacent that, what former French Prime Minister Valery Giscard d'Estaing called an exorbitant privilege, will be ours alone forever if we overreach and abuse it by weaponizing access to our currency and markets too broadly. Other countries will surely promote alternative centers of finance and mechanisms for settling international transactions.

In a rush to contain and decouple China, we should be careful not to do the same to us and to safeguard our institutional strengths.

Thank you.

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