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China: source of tectonic shifts in global finance

China's integration into the world will reshape the global financial system much like its economic integration did to the global economy

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Key points

- The steady transformation of China's balance of payments (BoP) is fundamentally reshaping its relationship with the rest of the world
- From a major economic power with limited financial clout, China is gradually opening its capital market – already the world's second largest – and internationalizing its currency
- This process will require structural shifts in China's financial system, propelling domestic monetary policy reforms and external liberalisation in its capital account and exchange rate
- A successful integration of China into the world could also trigger a compositional shift in the global financial system, leading to rebalancing of global capital to the tune of tens of trillions
- Carefully managing this process will be critical for ensuring stability for China and the world. Past episodes of liberalisation offer lessons for China to tailor its reform path given its unique size and development model
- China's economic integration profoundly remoulded the global economy over the past decades. We expect its financial integration to have a similar impact on the global monetary system going forward

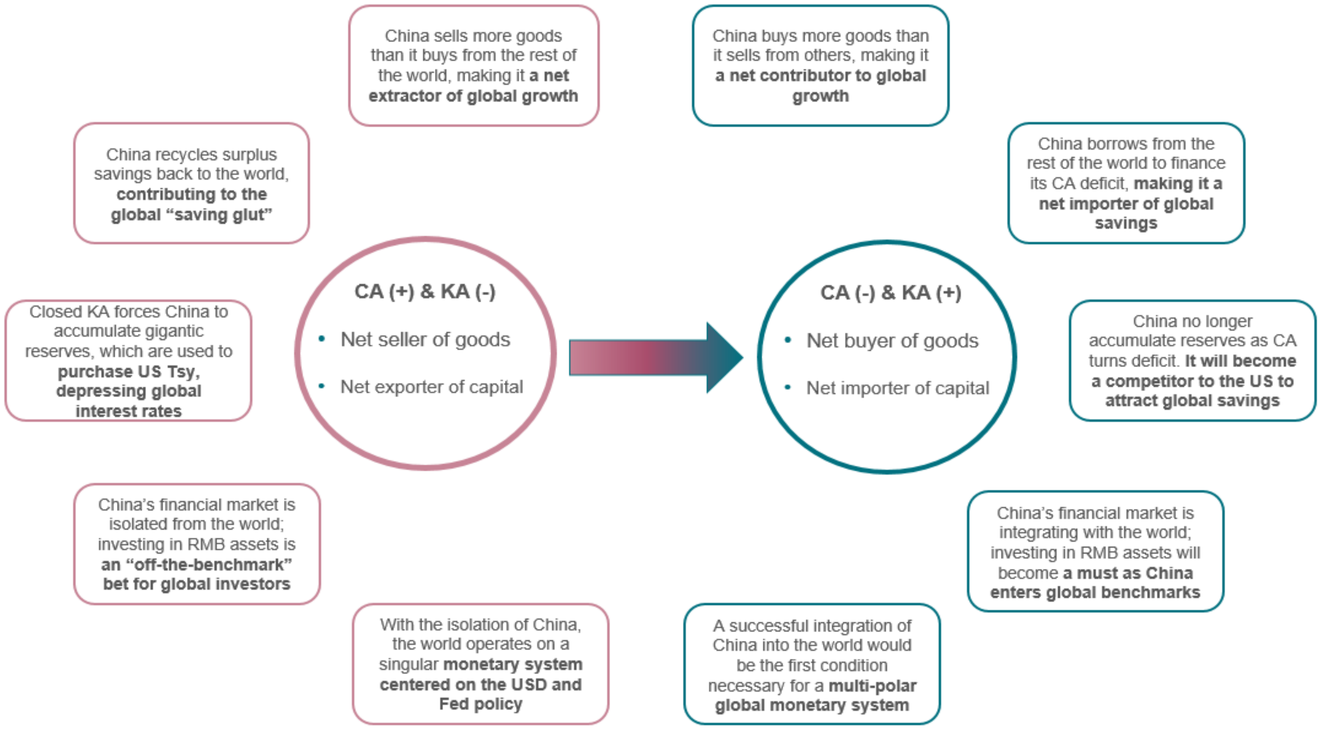
China's changing BoP: Why it matters

In part one of our three-part series documenting China's changing balance of payments (BoP), we highlighted the structural shift in China's current account (CA), explained its drivers and envisaged how the CA may evolve going forward. Under a scenario of broadly successful economic and social transformation – leading to further declines in the savings and investment rates – China would likely enter a new era of small, but persistent, CA deficits, which could have a profound impact on the rest of the world.

Exhibit 1 provides a summary of China's changing role before and after its BoP transformation on the global stage. A few examples can help illustrate its significance:

– **From growth extractor to growth contributor:** China has had a large CA surplus for many decades. This, in a crude sense, means that the country has sold more goods than it bought from the rest of the world, making it a net extractor of global growth. This situation could soon change with its CA moving into deficits. With imports outpacing exports, China would soon become a net contributor to global growth and a true engine of the global economy.

Exhibit 1: China's BoP transformation creates tectonic shifts in the global macro system



Source: AXA IM Macro Research – As of 02/09/19

– From capital exporter to capital importer: When a country runs a CA surplus, its capital account (KA) has to be in deficit to keep its balance of payments balanced. In the past two decades, China's large CA surplus has contributed to the so-called "global savings glut"[1] which was recycled mostly into US Treasury bonds. But with its surplus savings now vanishing, China will soon have to borrow from others to finance its CA deficits, making it a competitor to the US in attracting global savings.

– From off-the-benchmark to index heavyweight: China's onshore capital markets had, until recent years, been isolated from the world by its closed capital account. With no representation in global benchmarks, renminbi (RMB) assets were a niche asset class for only few investors with the expertise and risk appetite. However, the recent opening of the KA has raised the international profile of Chinese assets, allowing them to enter global indices. A continuation of this trend could see China becoming an index heavyweight, prompting significant capital flows to the onshore markets.

– From sideliner to active contributor to the global system: Over the very long term, successful liberalisation of the Chinese economy and financial markets could see an increasing use of RMB as an international reserve currency. This could shift the current global monetary system from its singular regime centred on the USD to a multi-polar system underpinned potentially by the dollar, euro and yuan.

Any one of the above changes would have far-reaching impacts, **together, they could fundamentally reshape of the global macro system.** In the following sections, we will explain the mechanism behind China's external-account liberalisation, its impact on global capital flows, and how Beijing may want to manage this process along with its risks and consequences.

China's IIPs to be reshaped by a liberal KA

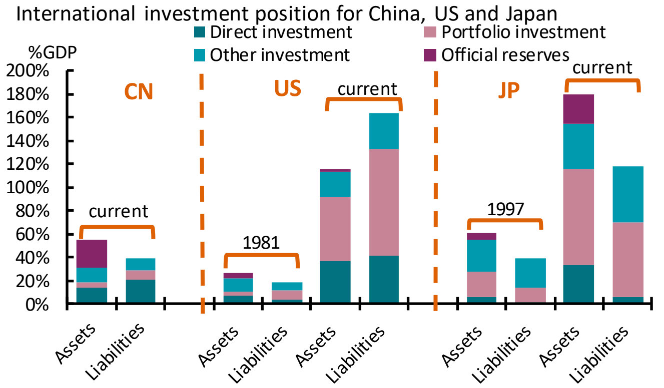
One way to assess the extraordinary distortions of China's BoP management is by looking at its international investment positions (IIPs). The IIPs provide a summary of a country's foreign assets and liabilities, which are a result of accumulated cross-border investments.

China's IIPs, in both assets and liabilities, are tiny compared to those of the US and Japan (Exhibit 2) as a result of its asymmetric management of the BoP. On the one hand, China's CA was fully liberalized by the end of the 1990s, paving the way for it to become a major force in global trade. On the other hand, the capital account was strictly controlled by Beijing to insulate the economy from volatile capital flows. The asymmetric management of the BoP – with an open CA endorsing economic integration, but a closed KA preventing

[1] Bernanke, B., "The Global Saving Glut and the US Current Account Deficit" Remarks by Federal Reserve Governor, 10 March 2005

financial integration – has driven a lopsided relationship between China and the world (Exhibit 3).

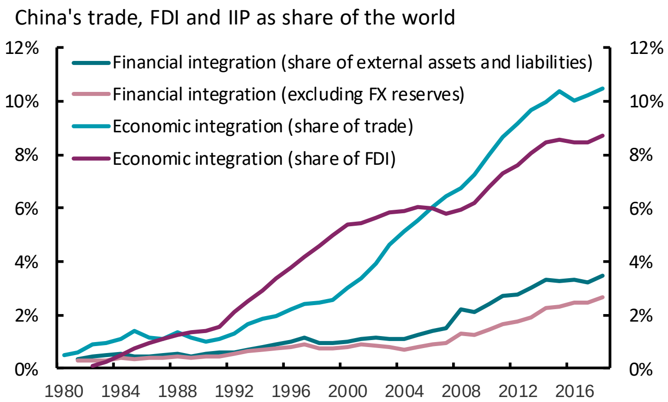
Exhibit 2: Capital control limits China's IIP



Source: International Monetary Fund (IMF) and AXA IM Macro Research – As of 02/09/19

These restrictions of the BoP have not only affected the growth of China's IIPs, but also their compositions. The latter is manifested in two main areas. The first is China's small portfolio of assets and liabilities. At only 12% of GDP, these positions are dwarfed by those of the US (147%) and Japan (146%) where no capital controls are exercised.

Exhibit 3: Unbalanced BoP control creates distortions



Source: IMF and AXA IM Macro Research – As of 02/09/19

The second difference is in the assets held in the form of official reserves. Total FX reserves account for nearly half of China's international assets, reflecting the critical role of the state in recycling its vast trade surpluses under a fixed exchange rate[2]. In contrast, the US does not have a large reserve holding, and for Japan, even with a history of reserve accumulation, the size of its assets is also smaller than China's[3].

Distortions are being unwound

However, the factors underpinning China's unbalanced BoP are now in reverse. Over the coming years, the turning of the CA, as discussed in part one of the report, will force Beijing to lessen its control on the capital account so that domestic debt and investment can be financed by foreign savings. China's currency, the RMB, should also become more flexible if the People's Bank of China wants to maintain monetary policy independence under freer capital flows[4]. A more market-driven exchange rate will in turn render the need for SAFE[5] to keep a large pile of FX reserves. A multi-faceted reform – propelled by the BoP transformation – could radically change the face of China's financial system over the coming decades.

China's BoP change to rebalance global capital

Precisely quantifying the long-term impacts of the BoP change is difficult. But estimating short-term capital flows – driven by the recent KA liberalisation and index inclusions of RMB assets – is more tractable. Over the past few years, Beijing has experimented with capital market liberalisation by allowing qualified investors to invest in and out of China via quota-based schemes like (R)QFII and QDII[6]. This was followed by the launch of Equity and Bond Connects, which dramatically eased onshore market access for foreign investors.

Those moves have won the approvals of international benchmark operators, leading to successive inclusion of RMB assets in global indices. From effectively zero weight some two years ago, RMB assets now account for nearly 2% of global reserve allocation, circa3% of the MSCI Emerging Markets Equity Index and circa1% of the Bloomberg Barclay's Global Bond Index.

These are only the beginning of a long march towards integrating the world's second-largest capital market. As more global benchmarks welcome China to their universe, a wholesale rebalancing of index composition could see hundreds of billions of foreign capital reaching China's shores over the coming years (Exhibit 4-5).

[2] This is because the private sector, after earning US dollars from CA (i.e. trade) transactions, was not allowed to invest the dollar freely because of the KA restrictions. Hence, they had to turn their USD to the government and rely on SAFE to recycle the earnings on their behalf.

[3] Compared to portfolio flows, China has been much more open to direct investments, i.e. foreign direct investments (FDIs) and outward direct investments (ODIs). The strong inflows of FDIs over the past decades have been instrumental to China's stellar economic performance. ODIs, on the other hand, have started later but have grown very rapidly in recent years thanks to the Road-and-Belt Initiatives. The differences between China and others in direct investments are not as large as those of portfolio and reserve positions.

[4] According to the theory of Impossible Trinity, a country cannot simultaneously have independent monetary policy, a free capital account and managed exchange rate.

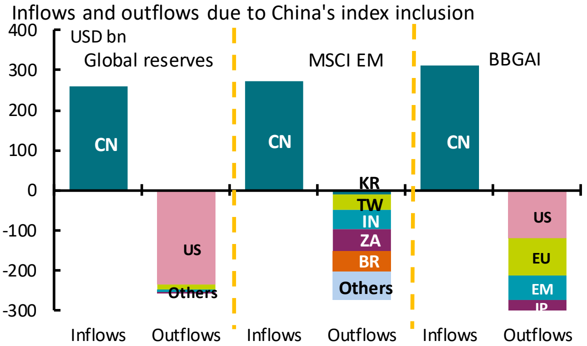
[5] State Administration of Foreign Exchange, the agency which manages China's $3.1tn FX reserves.

[6] (RMB) Qualified Foreign Institutional Investor and Qualified Domestic Institutional Investor schemes

Exhibit 4-5: Bond and equity inflows due to index inclusion

	Current	Mid-term	Long-term	Estimated inflow USDbn
Global reserves	1.9%	3.4%	5.0%	**258**
BBGAI	0.6%	3.5%	6.4% (by 2020)	**240~382**
MSCI				**377**
ACWI	0.2%	0.4%	1.8%	64
EM	1.5%	3.3%	16.2%	274
AxJ	1.7%	4.0%	17.2%	39

Source: MSCI, various sources and AXA IM Macro Research – As of 02/09/19



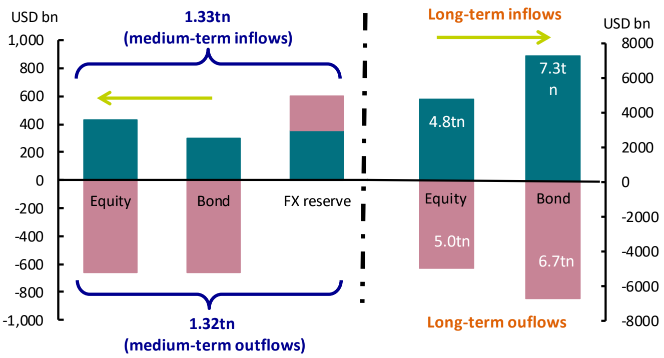
Source: Standard Charted Bank, MSCI, IMF and AXA IM Research - As of 02/09/19

Just as global investors are embracing China, Chinese investors will want to diversify their investment overseas too. However, outbound capital flows from China have so far been more restricted due to the official concern over currency depreciation and capital flight. While these controls may stay in place for the time being, a successful financial integration will eventually require the liberalisation of outbound flows too.

Should that happen, China's International Investment Positions will likely expand significantly in the coming years, perhaps similar to what the US and Japan experienced in the 1980s and 1990s. A simple convergence of China's IIPs to those of the US could drive tens of trillions of cross-border flows, by our estimate, over the coming decades (Exhibit 6)[7].

Exhibit 6: China's open-up triggers vast capital flows

Estimated capital in/outflows over medium and long-term horizons



Source: Various sources and AXA IM Macro Research – As of 02/09/19

Supplementary reforms needed for KA open-up

Despite the vast potential to attract global capital, the success of China's financial integration is by no means guaranteed. Beijing has to undertake a number of important reforms to win the trust and confidence of international investors in its capital markets. These include:

- Unwinding structural imbalances by rebalancing the economy and containing systematic risks. To achieve these, Beijing needs to diligently implement structural changes to upgrade its economy, revive productivity growth and defuse the leverage time-bomb.

- Improving financial regulations by further liberalising the onshore markets. This would also entail converging China's capital market infrastructure to global standards and scaling back the implicit guarantee that has hindered an efficient allocation of financial resources.

- Internationalising the RMB and reforming the FX pricing mechanism. The latter should be a result of China opening its capital account and maintaining monetary policy autonomy. The internationalisation of the RMB will require, for instance, a global proliferation of local-currency bonds that enables China to borrow in its own currency. This would make China's external debt more sustainable than the foreign-currency-denominated (mainly USD) borrowing of many EM countries[8].

[7] Exhibit 6 is constructed as follows: medium-term equity and bond inflows are based on estimates of passive inflows from index inclusion of A-shares and RMB bonds in global indices. Equity and bond outflow estimates are benchmarked against the increase in gross international assets of Japan and Germany when they opened their capital accounts in 1980 and 1981 respectively. FX reserve inflows are calculated by assuming that RMB assets will account for c. 5% of global reserves, similar to the weight of sterling currently. Reserve outflows are negative, as China needs to lower its reserve holdings once the capital account and exchange rate become more liberal. Hence, it adds to inflows. Finally, long-term capital flows are estimated assuming that China will eventually have similar international investment positions like the US currently.

[8] This is one of the key benefits of having an international reserve currency, which the US enjoys for decades with the dollar.

Risks need to be managed

Vast cross-border flows can come with vast risks if the liberalisation process is not properly managed. On the one hand, a big-bang approach – entailing very rapid KA open-up – could make China vulnerable to volatile capital flows that were partly responsible for the financial crises in Latin America and Asia. On the other hand, Beijing can no longer resist liberalisation completely given the structural shifts in its economy and society. Experiences of Argentina – which refused to open-up in the early 20th century, and Japan, which failed to implement the right reforms after the Plaza Accord – offer important lessons for China to avoid similar perils in its own liberalisation process.

We think Beijing will carry out the necessary reforms and carefully sequence the domestic and external changes, while keeping a close eye on systematic risks. The emphasis on risk management has underscored the authorities' asymmetric control of inbound versus outbound flows in recent years, which has contributed to the general stability in the macro environment[9].

These risk managements can affect the speed and shape of financial liberalisation but should not impact its overall direction. As this process continues steadfastly, a dramatic rebalancing of international capital could trigger tectonic shifts in the global financial landscape. The significance of this development could, in our view, rival China's integration into the global economy over the past 40 years.

[9] Many of the liberalisation moves could bring a material loss of control for the Chinese authorities over capital flows, currency movements, financial markets and therefore over broader global influences over the domestic economy. One risk is that Beijing walks back on these must-needed reforms that could turn China into a more liberal, market-driven and integrated economy and instead choose to retain heavy-handed controls. Some may say the slower liberalisation on outbound flows since 2015-2016 was an indication that the authorities are not yet fully prepared to relinquish control. We think the pace, form and scale of future reforms will be carefully managed and only carry out if the overall macro stability can be ensured.

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