

Economics

China's Double Edged Sword: How to Lure Cash But Keep Control


By [Chris Anstey](#) and [Enda Curran](#)

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▶ Rising foreign investment raises stakes for policy competence

▶ Shock to confidence could see overseas money flow back out

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Invest for the long term.

China H-Share Banks to Outperform, CEB International's Lam Says

China's increasing success at luring global investors to its stock and bond markets may be laying the seeds of future volatility as its financial system becomes subject to overseas sentiment like never before.

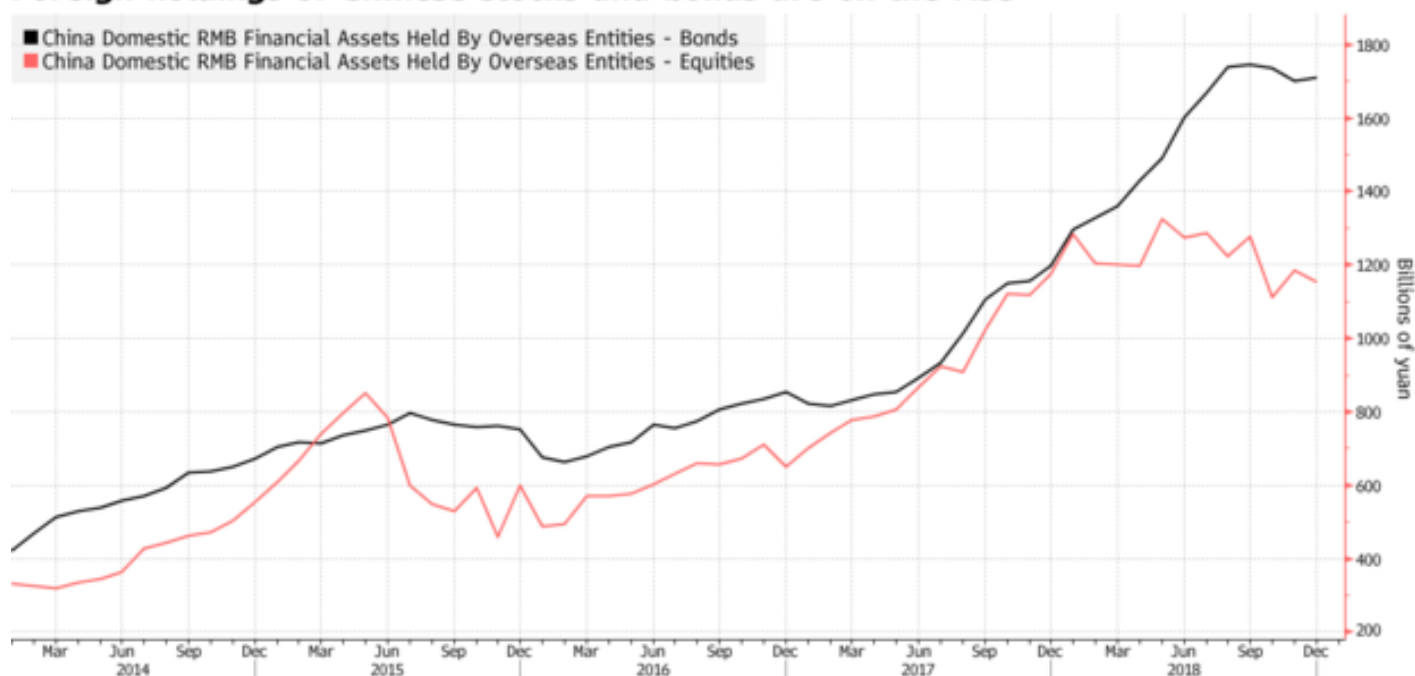
The country's years-long campaign to attract steady streams of foreign capital is now paying off, providing support for the yuan in the face of diminishing current-account surpluses. Foreign ownership of Chinese bonds has climbed to a record of more than \$260 billion, while holdings of stocks stood at \$172 billion in the most recent data.

Wider inclusion of Chinese assets in global bond and equity indexes will offer China a fresh source of funding, the need for which was underlined Tuesday when the government widened its budget-deficit target and boosted plans for local-government debt issuance. Capital inflows will also cushion a shrinking current account surplus that the International Monetary Fund tips to fall further over coming years.

“China’s increasing openness to foreign investors will help in the development of its financial markets -- but at the risk of increasing exposure to capital flow volatility, which will also complicate exchange rate management.” said Eswar Prasad, the former head of the IMF’s China section who is now at Cornell University.

Trending Up

Foreign holdings of Chinese stocks and bonds are on the rise



Foreign investors hold less than 3 percent of China’s domestic bonds and equities, making them marginal players for now, although they’ve had increasing impact on the government debt which forms the bulk of their bond holdings. Their sway is set to rise as the country’s weightings in global portfolios expand. Similarly, China’s impact on those portfolios will rise.

“This will be a double edged sword: more access but also more transmission of volatility to the global market,” said Hui Feng, a senior research fellow at the Griffith Asia Institute and co-author of “The Rise of the People’s Bank of China.”

Last week, MSCI Inc. announced it will boost onshore Chinese stocks in its emerging-market index to 3.3 percent by November, from 0.72 percent now. Next month, Chinese government and

policy-bank bonds are set for a phased inclusion in the Bloomberg Barclays Global Aggregate Index that will bring China's share to an estimated 6 percent. Bloomberg LP owns the Bloomberg Barclays indexes, and is the parent of Bloomberg News.

What Bloomberg's Economists Say

“For foreign investors, issues such as insufficient information, lack of transparency, pricing distortions created by implicit government guarantee and policy swings in capital flow management are major hurdles for investing in China bonds. Even so, these should not stop long-term allocation into China's bond market.”

--Chang Shu and David Qu, Bloomberg Economics, Hong Kong

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The decisions marked wins for Chinese officials who have sought a stable source of capital inflows to balance long-standing pressure from Chinese companies and individuals to park money overseas. The efforts became all the more important after the country saw a \$1 trillion slide in its foreign-exchange reserves in the wake of a messy yuan devaluation in 2015.

To be sure, China's tightly controlled capital account gives the government ample opportunity to clamp down on cash moving into or out of the country. That offers a vital buffer against the kind of capital flight that typically destabilizes emerging economies.

Communication Challenge

Yet the implicit vulnerability to a sudden outflow of foreign holdings raises the stakes for China to enhance its communication efforts on regulatory changes, to avoid anything like the instability seen in 2015 and 2016. If done right, the increased participation of global investors could actually reduce volatility by increasing the diversity of asset buyers.

“The U.S. stock market attracts a large amount of capital from the world. Did that make it more vulnerable over the last decades? No, it actually helped it become the largest and a very efficient stock market,” said Rujing Meng, who lectures on finance at the University of Hong Kong

For now, China needn't worry, as it's likely to see sustained net inflows for the foreseeable future given the low starting point, economists say. Most of the purchases of bonds have come from central banks and sovereign wealth funds, with private-sector fund managers only starting to diversify portfolios to include China.

China's sheer economic weight and massive pool of domestic savings also offer buffers that the likes of Argentina and Indonesia don't have.

Early Stages

"Foreign investors are in the early stages of a major commitment to Chinese equities," Morgan Stanley economists and strategists wrote last month in a report on the "transformation" of China's capital flows. Similarly, "bond inflows into China have the potential to pick up significantly in the coming years," they wrote, predicting steady appreciation in the yuan as a result.

Winning those long-term inflows will require easing the concerns of some investors that China could lock up their money in cases of extreme moves.

"When volatility spikes there, it could be tricky for investors if they can't trade bonds and A-shares freely," said Jean-Louis Nakamura, Asia-Pacific chief investment officer at Lombard Odier, using the term for domestically listed shares. "In China, rules can change overnight. We need to have assurance and policy clarity first."

– *With assistance by Molly Dai*

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CNY

China Renminbi Spot

6.7182 CNY ▲ +0.0190 +0.2836%

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BARCLAYS PLC

155.44 GBP ▼ -5.14 -3.20%

3988

BANK OF CHINA-H

3.66 HKD ▲ +0.00 +0.00%

MSCI

MSCI INC

191.86 USD ▼ -3.81 -1.95%

MS

MORGAN STANLEY

41.72 USD ▼ -1.41 -3.27%