

# **China's Financial Integration with Asia**

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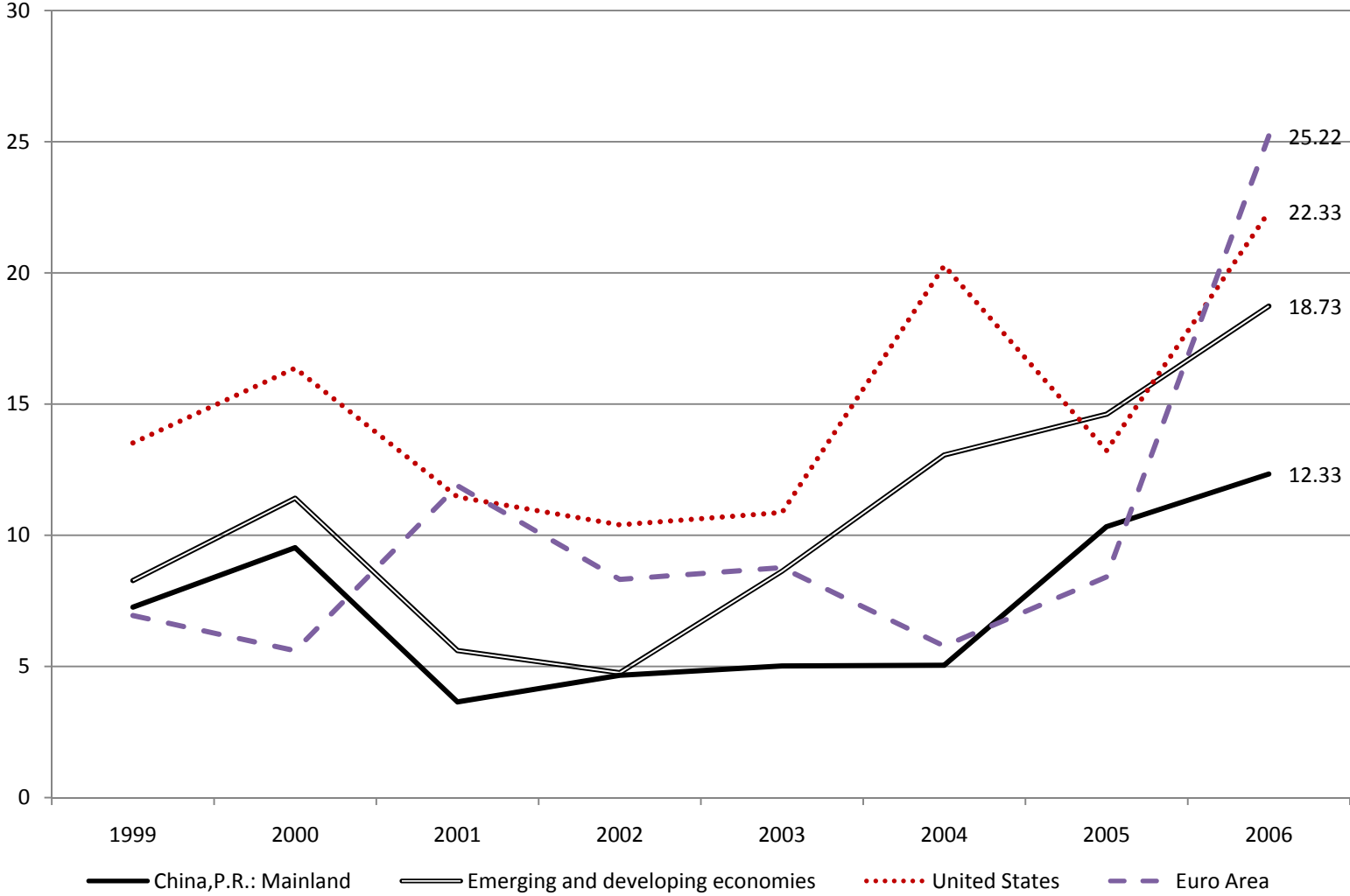
IWEP, CASS

Tokyo Club, Tokyo, December 11-12, 2008

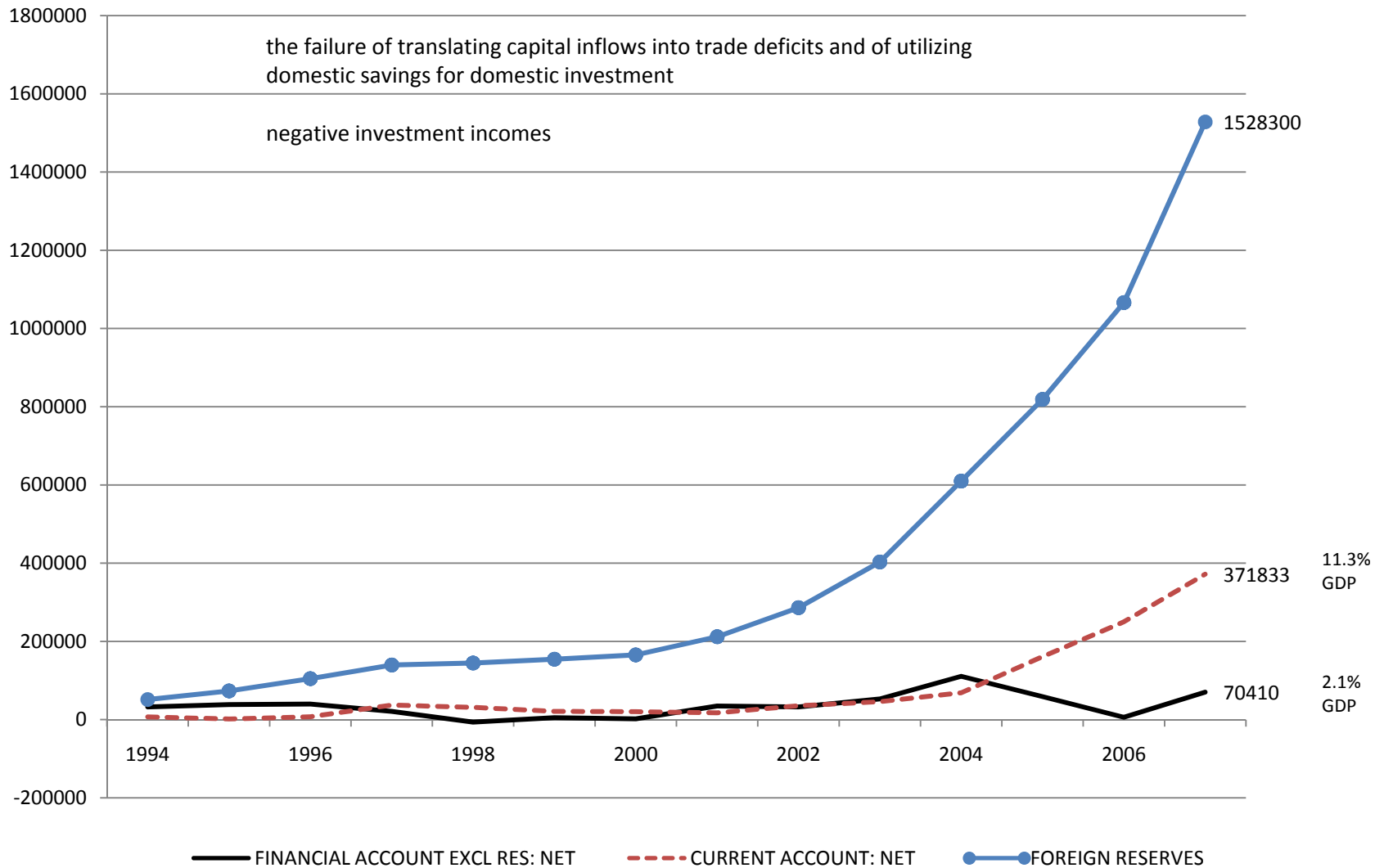
# plan

- **An overview of China's capital flows**
- Sluggish financial openness
- Twin surpluses
- Coping with hot money
- Patterns and determinant factors of China's capital flows
- **China's financial integration with Asia**
- China's reliance on FDI inflows from Asia
- China's portfolio investment with the rest of Asia
- China's empirical financial link with the rest of Asia
- **China's financial institutional cooperation with Asia**
- China's policy response to the financial crisis of 1997-98
- China and the CMI
- China and regional bond market
- China and regional collective currency arrangements

# Sluggish financial openness (liabilities + assets /GDP)



# Twin surpluses (1994-2007, \$ million)



# Coping with hot money

**Table 2: Estimation of hot money in China (US dollar billion)**

	2003	2004	2005	2006	2007	2008Q1
Adjusted change of reserves	135.2	181.2	225.6	192.9	631.6	133.3
--Trade surplus	25.5	31.9	101.7	177.6	262.0	41.5
-- FDI	54.4	60.6	60.3	69.5	82.7	27.4
+ non remitted profit	0	0	60.1	121.5	183.5	13.0
+ hot money from trade surplus	40.3	51.1	67.8	71.6	70.6	19.0
<b>Hot money</b>	95.6	139.8	191.5	138.9	541.0	96.4

**Source: Zhang and Xu (2008)**

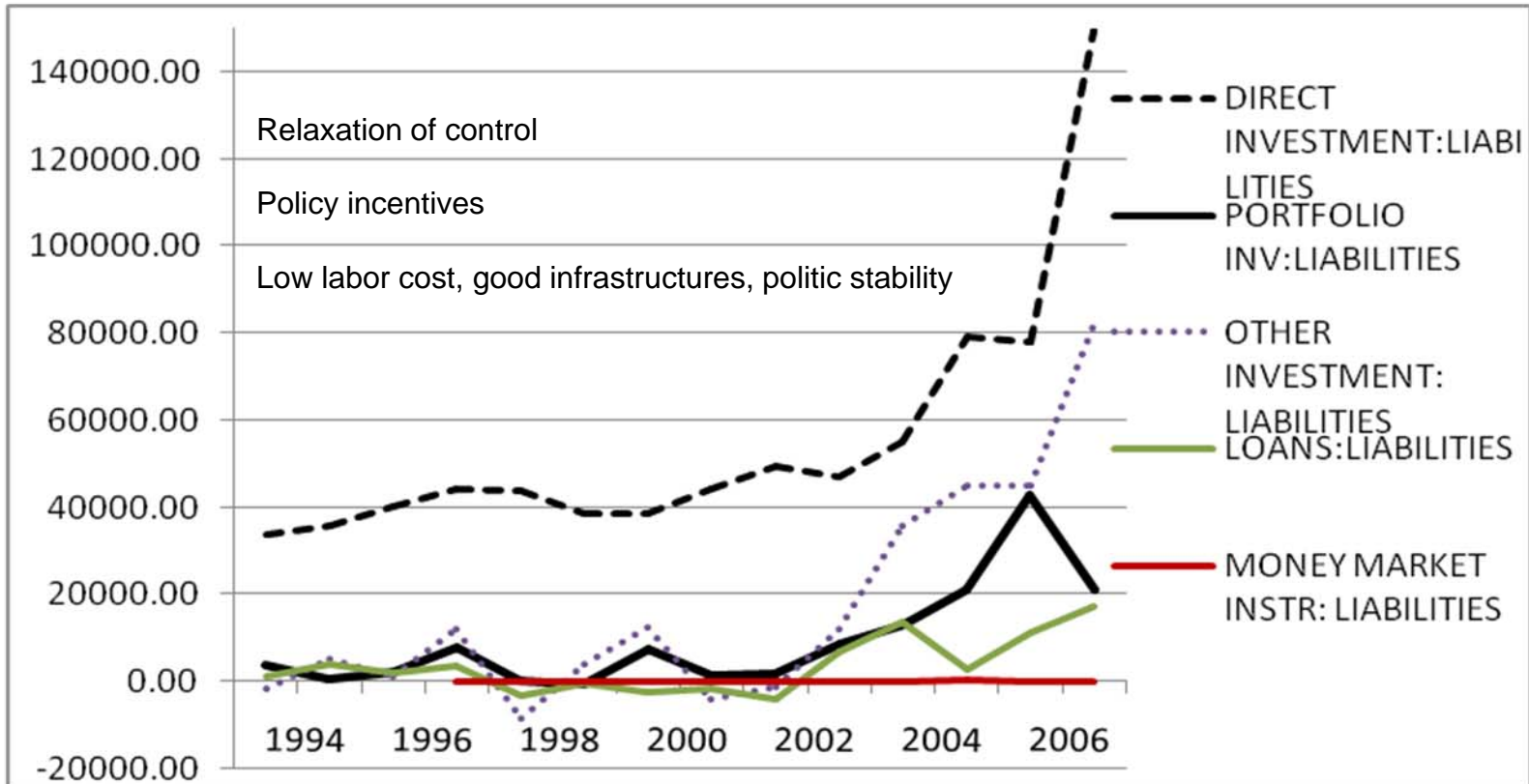
- invited by expectations for RMB exchange rate appreciation since 2003
- stimulate by liberalizing controls on stock market
- chase Chinese asset prices in the equity and property markets in 2007
- fuel strong monetary growth and additional inflationary pressure
- a new round of debate about the effectiveness and pace of capital account liberalization

## Controls on capital account transactions in China (as of Feb. 2007)

		Inflows	Outflows
Direct investment		Free Inward remittance converted into Renminbi	Free Subject to SAFE reviewing sources of foreign exchange assets investments abroad.
Stock market	nonresidents	Purchase B shares and QFIs subject to a set of limitations	Sale B shares, repatriate of QFIs
	residents	Sale B, H, N and S shares abroad	QDIIs
Bonds and other debt securities	nonresidents	QFIs	International development agencies are permitted to issue RMB denominated bonds locally, with the approval of the MOF, the PBoC, and the National Development and Reform Commission.
	residents	Prior approval by State Council for Examination and SAFE. Earnings should be repatriated.	Authorized entities (insurance companies, securities firms and qualified domestic banks) may purchase foreign bonds that meet rating requirement, subject to approval of the CIRC and the SAFE.
Money market	nonresidents	QFIs	No permission
	residents	Bonds with less than one year duration and commercial instruments, approval by the SAFE.	Authorized entities (insurance companies, securities firms and qualified domestic banks)
Collective investment securities	nonresidents	QFIs invest in domestic closed-end and open-end funds.	No permission
	residents	Prior approval by State Council for Examination and SAFE. Earnings should be repatriated.	No permission for residents, except authorized entities
Derivatives and other instruments	nonresidents	No permission	No permission
	residents	Operations in such instruments by financial institutions are subject to prior review of qualifications and to limit on open foreign exchange position.	Banking institutions with approval by CBRC for the purpose of risk hedging, not for speculation. Non-financial institutions through approved business of local financial institutions with no prior permission, but through foreign financial institutions with prior approval by the SAFE.

# FDI: dominant inflows

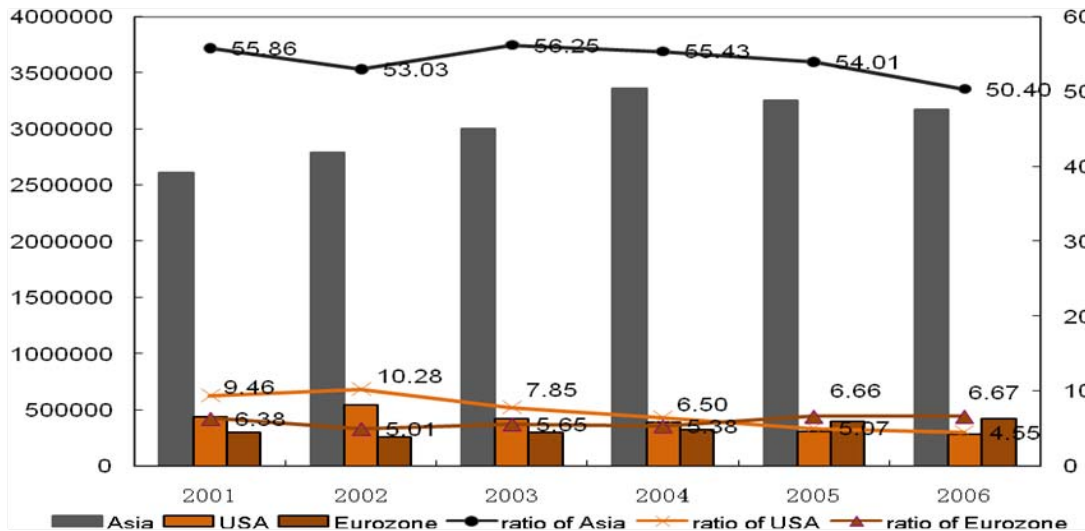
**Figure 3: China's capital inflow structure (US dollar million)**



**Source: China's Balance of Payments Report for 2007, SAFE.**

# FDI inflows from Asia

Figure 9: Origins of FDI inflows to China (0.01 million US dollar, % of total)



- 50%+ from Asia
- reflecting vertically integrated regional supply chains
- As an assembly hub, inviting foreign ownerships with capital and technology and exporting final goods to the rest of the world with relatively low domestic value added
- 63.7% from HKSAR

Source: China statistical yearbook.

Table 3: Source of China's FDI inflows in Asia (percent of China's total inflows from Asia)

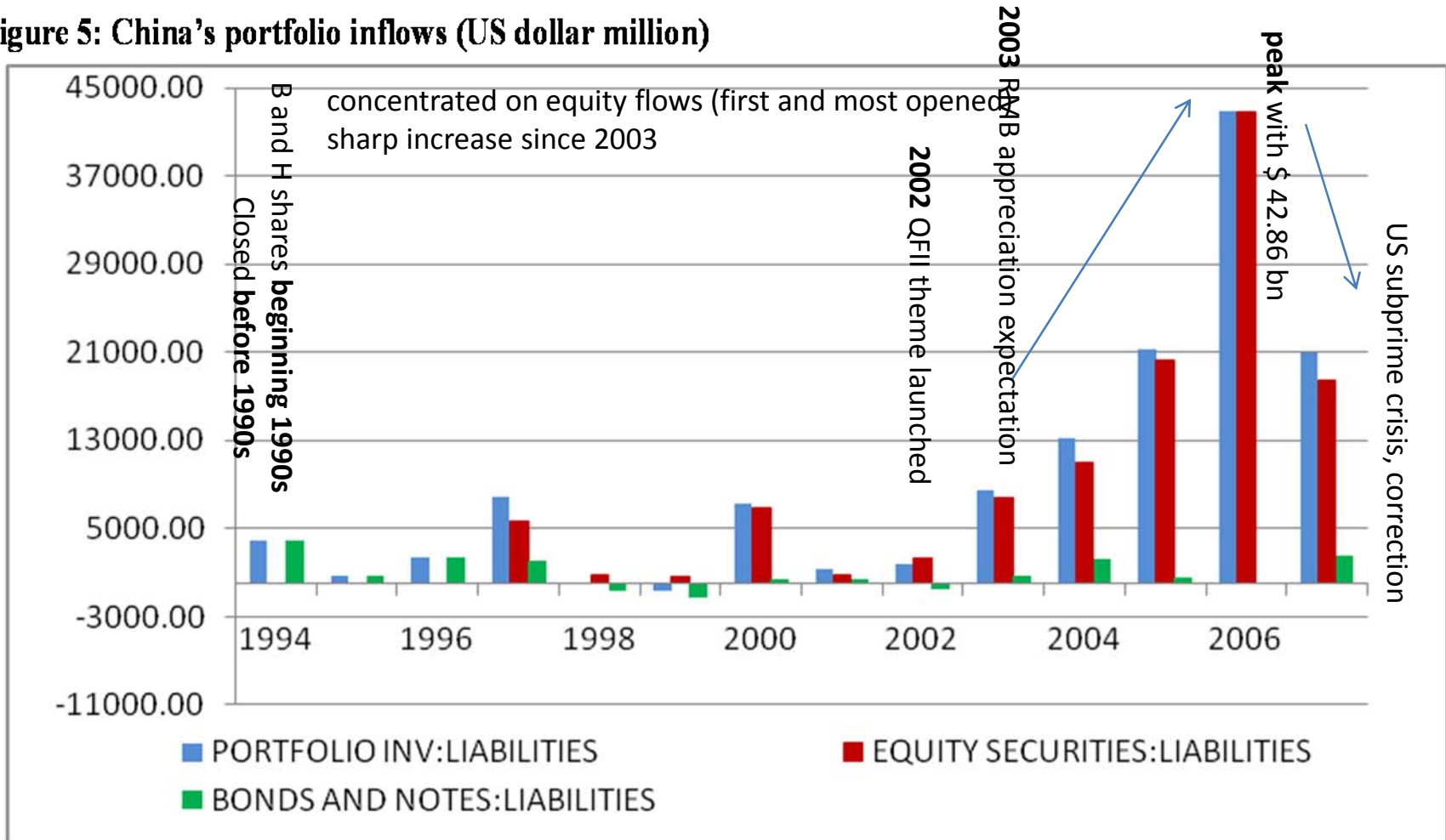
	2001	2002	2003	2004	2005	2006
HKSAR	63.84	63.85	58.81	56.53	55.08	63.71
Japan	16.61	14.98	16.79	16.22	20.04	14.48
Korea	8.22	9.73	14.91	18.59	15.86	12.26
Singapore	8.19	8.36	6.84	5.98	6.77	7.12
ASEAN 4	3.16	3.09	2.64	2.68	2.25	2.43

Source: China Statistical Yearbook.



# Portfolio inflows: Less diversified

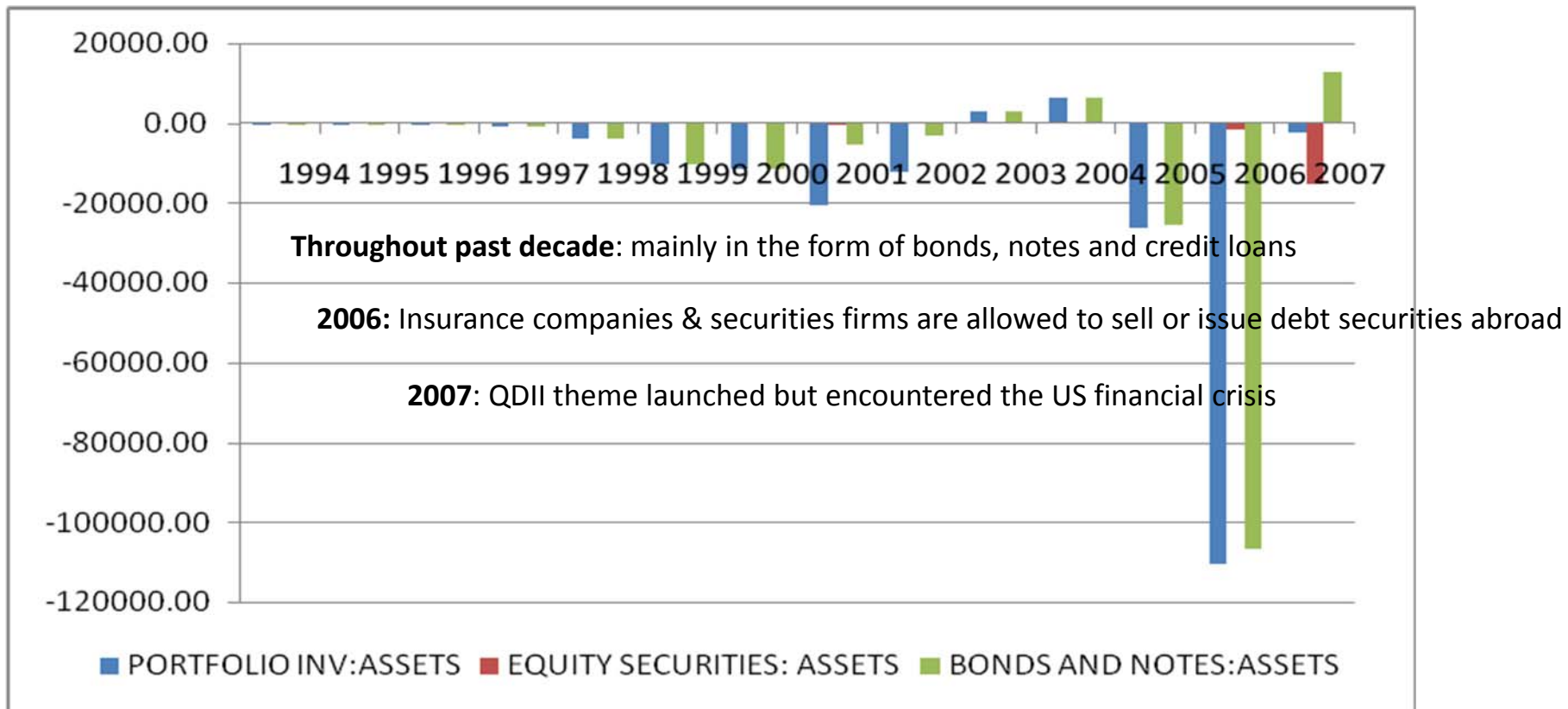
Figure 5: China's portfolio inflows (US dollar million)



Source: BOP, IMF; China's Balance of Payments Report for 2007, SAFE.

# Portfolio outflows: limited channels

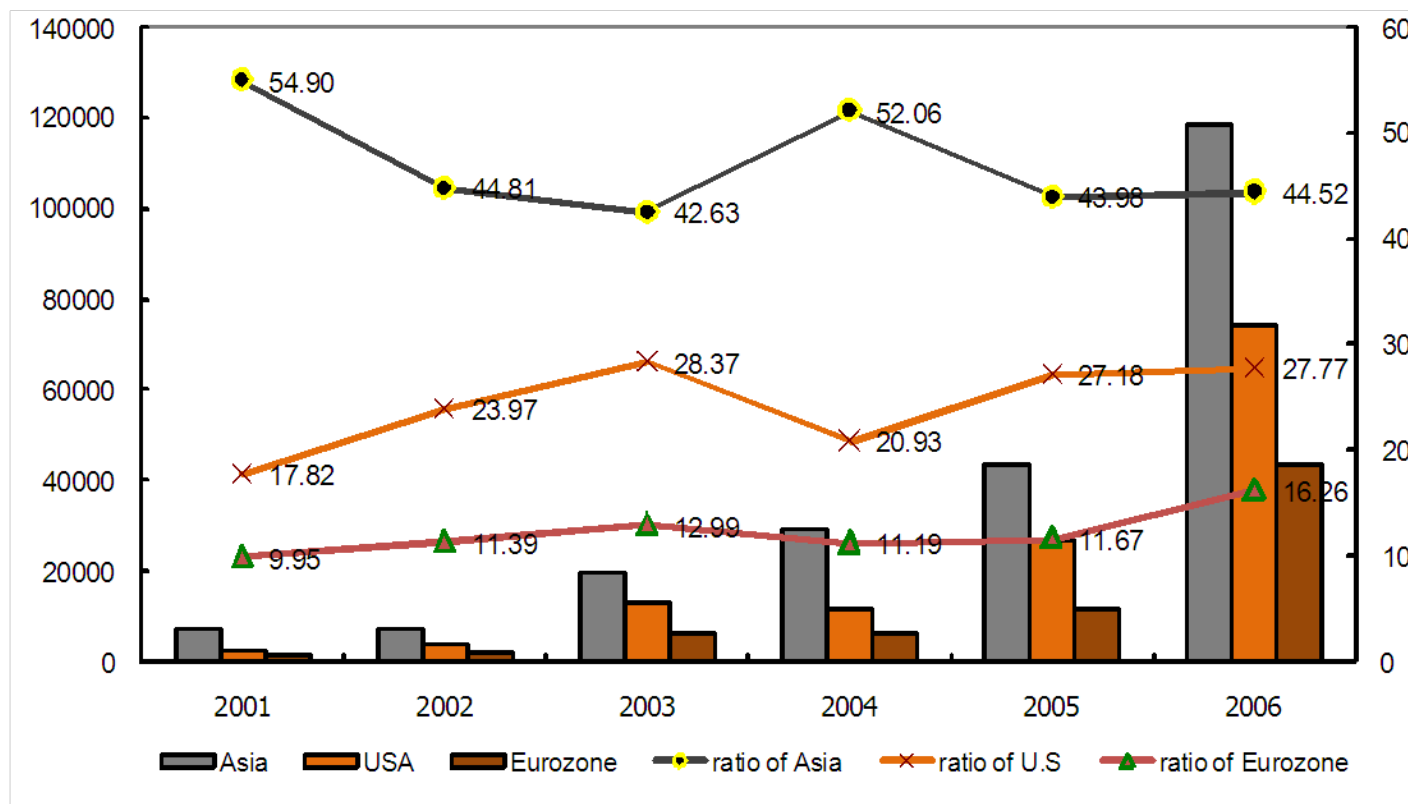
**Figure 6: China's portfolio outflows (US dollar million)**



**Source: BOP, IMF; China's Balance of Payments Report for 2007, SAFE.**

# Asia is the major source of inflows

**Figure 10: Origins of portfolio investment in China (inflows, US dollar million, % of total)**



Source: IMF, CPIS.

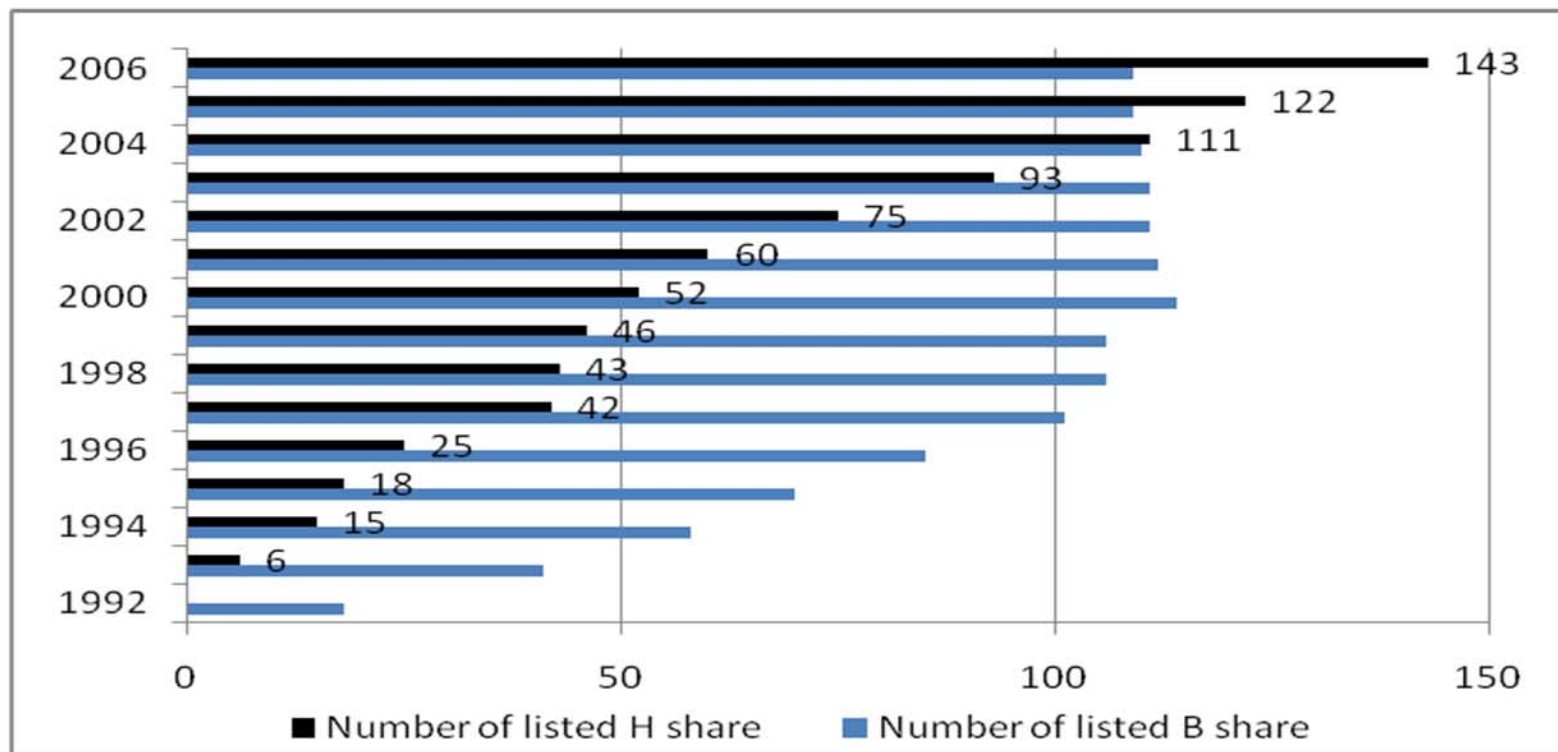
## HKSAR is the dominant source of equity inflows

	2001	2002	2003	2004	2005	2006
<b>HKSAR</b>	<b>74.64</b>	<b>73.06</b>	<b>79.72</b>	<b>78.34</b>	<b>79.96</b>	<b>84.41</b>
<b>Japan</b>	<b>10.81</b>	<b>11.92</b>	<b>10.67</b>	<b>14.48</b>	<b>8.39</b>	<b>8.32</b>
<b>ASEAN 5</b>	<b>14.34</b>	<b>14.97</b>	<b>9.41</b>	<b>6.99</b>	<b>11.62</b>	<b>5.85</b>
<b>Singapore</b>	<b>14.18</b>	<b>14.86</b>	<b>9.18</b>	<b>6.95</b>	<b>11.59</b>	<b>5.83</b>
<b>Korea</b>	<b>0.11</b>	<b>0.02</b>	<b>0.07</b>	<b>0.10</b>	<b>0.02</b>	<b>0.63</b>

## equity inflows

Overseas listing policy (H share) with agenda of SOEs reform  
the stimulus for equity inflows from HKSAR

Figure 12: China's listed companies in HK

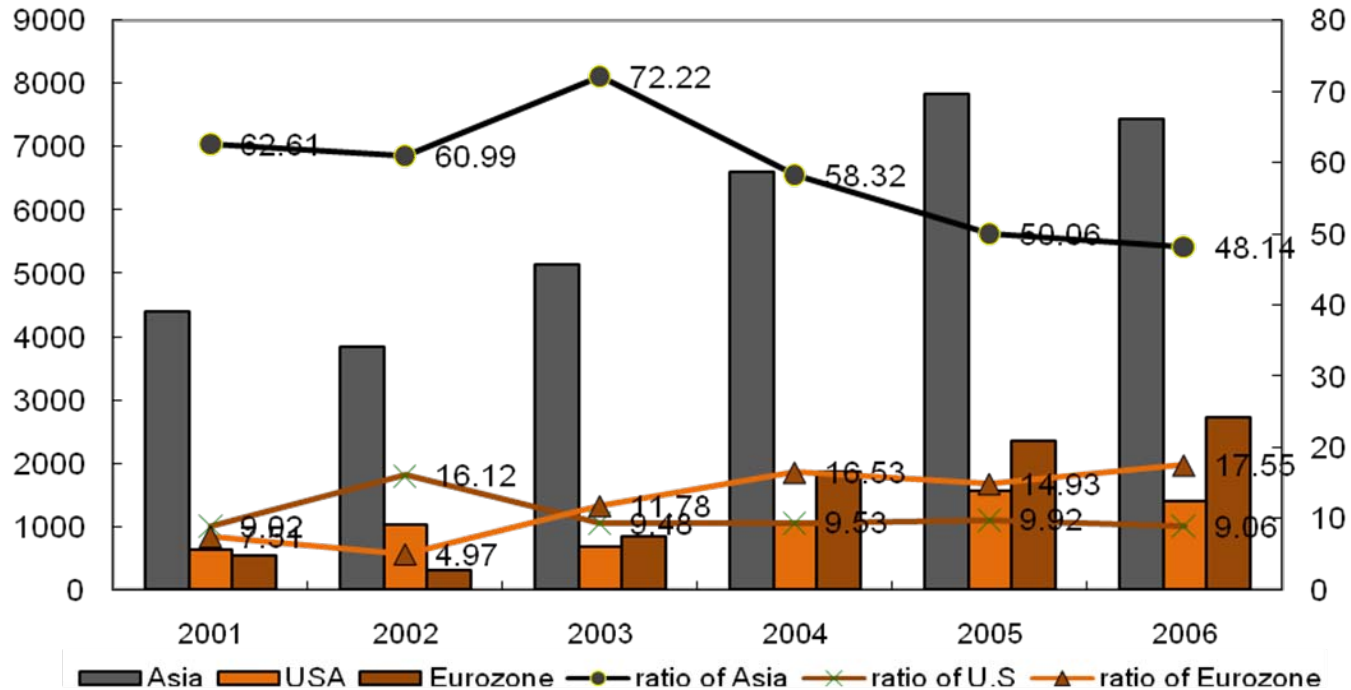


Source: China's Securities and Futures Statistic Year Book, 2007.

# debt securities inflows

debt securities inflows mainly come from Asia

**Figure 13: Origins of debt securities investment in China (US dollar million, % of total)**



**Source: IMF, CPIS.**

## debt securities inflows

HK is the major source of debt securities inflows

HK as a financial center for China

RMB bond issued in HK ( RMB 10 bn)

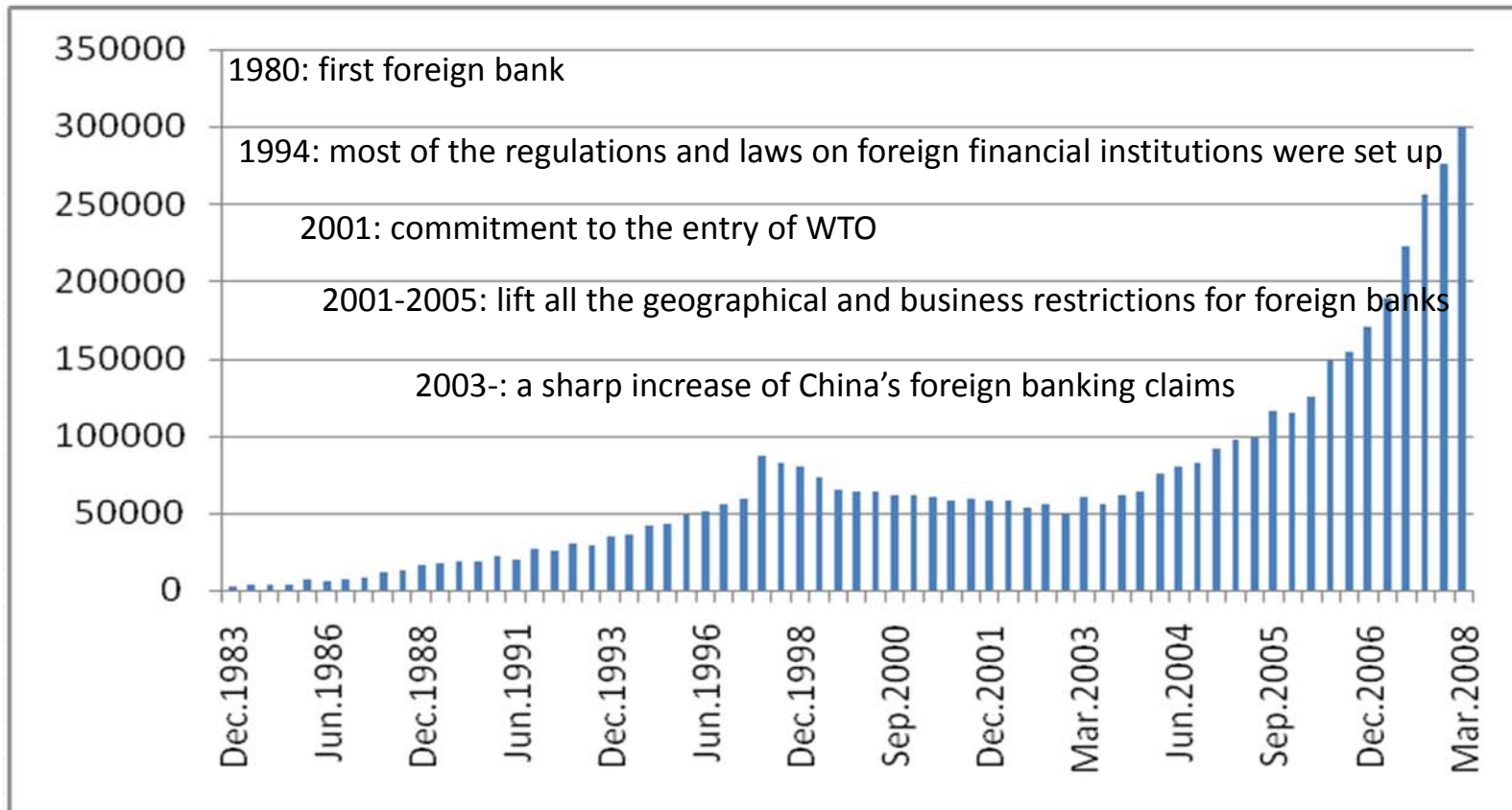
**Table 5: Geographic distribution of China's debt liabilities within Asia (percent of China's total from Asia)**

	2001	2002	2003	2004	2005	2006
HKSAR	71.93	73.0	79.45	79.18	80.46	84.35
ASEAN 5	<b>9.36</b>	11.02	12.66	8.58	10.51	10.25
Singapore	9.36	11.02	12.46	8.51	9.15	10.21
Japan	14.36	13.09	10.27	13.38	7.93	8.25
Korea	1.34	0.47	0.39	0.34	0.2	1.56

**Source: IMF, CPIS.**

# Banking sector's opening

Figure 7: China's banking foreign claims in total / Amounts outstanding / US dollar million



Sources: BIS



# Banking sector's opening: share in China's banking assets

**Table 1: Business outlets and assets of foreign banks in China**

	2003	2004	2005	2006	2007
Operational banking entities	192	211	254	312	440
Assets (RMB 10 million)	4159	5823	7155	9279	12525
Share of total banking assets in China (%)	1.50	1.84	1.91	2.11	2.38

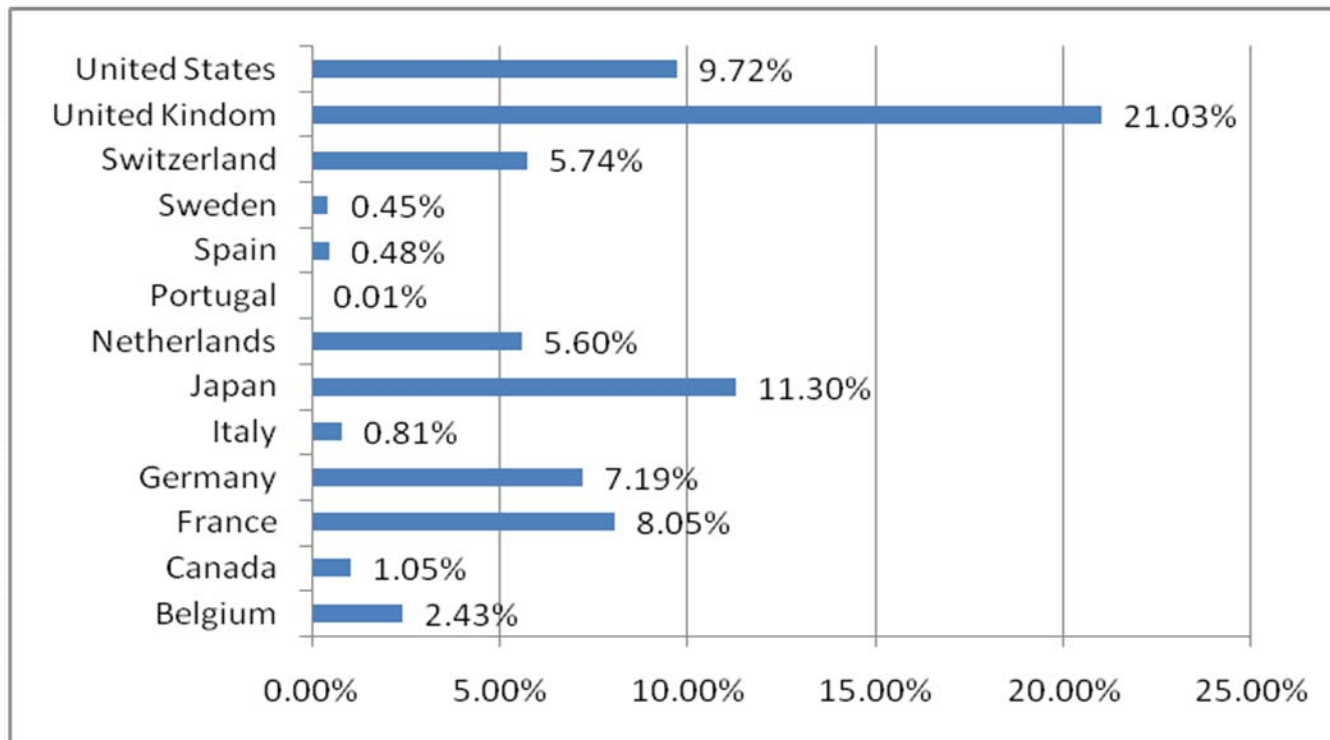
**Sources: China banking Regulatory Commission 2007 Annual Report.**

The **assets of foreign banking** institutions amounted to **RMB1.25 trillion yuan**

that accounted for **2.38% of the total banking assets in China.**

## Banking sector's opening: major foreign players

Figure 8: China's banking foreign claims (outstanding, US dollar million, end of March 2008)



Sources: BIS

# China's empirical link with Asia

- Capital control, inflexibility of interest rate and domestic prices .....in China make it difficult to assess bilateral price correlations based on a comprehensive set of indicators covering the money market, bond markets, equity markets and banking markets, and indicators related to market infrastructures between China and Asia.
  - ADB (2007): bilateral correlations between China's **equity index** and the indexes of other Asian countries were generally negative during 1990-1996. But all of them turned into positive in the post-crisis period of 2000-2007.
  - Gao (2007): test on common trend of prices in terms of real exchange rates based on OCA reflecting a broad fundamental link: (1) China, Japan, Korea and ASEAN; (2) China, Japan and Korea.
- Mixed results at regional level:
  - **co-movements in interest rates and bond yields** increased in recent years (Cowen et al 2006)
  - **interest rates** in Asia have increasingly converged since 1997-98 crisis (Kim and Lee 2008)
  - **cross-country money market rate and bond yield differentials** have fallen dramatically over the past decade (ADB 2007)
  - **covered interest parity** was rejected (Carcia-Herrero and Wooldrudge 2007)
  - **consumption** growth in most Asian countries remains uncorrelated (Mercereau 2005)

# China's financial institutional cooperation with Asia

## China's policy response to the financial crisis of 1997-98

- China was praised as a big country with responsible reaction to region-wide currency deprecation for keeping its currency stable in the crisis of 1997-98.
  - the first time that both China and Asian economies started realizing that China's financial policy choices would have a strong regional effect.
- Reflection of China's preference in the formation of external financial policies:
  - used to regard global financial organizations as an optimal solution
  - initial "mute" response to Japan's proposal of Asian Monetary Fund
  - turned to be positive as China realized spillover effects of crisis
  - market forces from China's increasing financial integration with Asia
  - police incentives from further liberalization of China's capital account

## China and multiple forums/arrangements

	Finance Ministries			Central banks		
economic dialogue forums	ASEAN+3 13 regional	MFG 14 suspended	APEC 21 trans-regional	ASEM 25 +EU15	SEANZA 20 +Aus and NZ	EMEAP 11
Year established	1999	1997	1994	1997	1959	1991
China	▲	▲	▲	▲	▲	▲

## RMB and CMI, July 2007

China-Thailand	One-way	US dollar/Baht	USD 2 billion	Concluded: 6 Dec. 2001 Expired: 5 Dec. 2004
China-Japan	Two-way	Renminbi/Yen; Yen/Renminbi	USD 6 billion	Concluded: 28 Mar. 2002
China-Korea	Two-way	Renminbi/Won; Won/Renminbi	USD 8 billion	Concluded 24 Jun. 2002
China-Malaysia	One-way	US dollar/Ringgit	USD 1.5 billion	Concluded: 9 Oct. 2002
China-Philippines	One-way	Renminbi/ Peso	USD 2 billion	Concluded: 29 Aug. 2003 Amended: 30 Apr. 2007
China-Indonesia	One-way	US dollar/Rupiah	USD 4 billion	Concluded: 30 Dec. 2003 Amended: 17 Oct. 2006

## China and US\$ 80 billion of regional reserve pool, 2008

China Japan Korea	ASEAN
80 %	20 %

## China and regional bond market

- ABF 1 and 2:  
ABF1 was only denominated in US dollar  
ABF2 allows local currencies to denominate bond issuances  
RMB is correspondingly used in the China Fund issuance.
- HK as an intermediate center
- Domestic barriers  
limited size and immaturity of domestic bond market  
capital controls ( fixed income market)

## China and regional collective currency arrangements

- Asian emerging economies are generally dollar pegging.
- China's new exchange rate policy hasn't changed much of dollar's dominant weight.
- Need for a regional collective currency arrangement is still in doubt.
- Existing proposals such as Common Currency Basket by Williamson (2000, 2005) and G-3 Basket by Ogawa (2002) are irrelevant for local currency's role.
- The Asian Monetary Unit (AMU) by Ogawa and Shimizu (2005) or Asian Currency Unit (ACU) by the ADB (2005) was meaningful but with difficulties in implementation and lack of positive acceptance by participating countries.
- Thinking about RMB's role ?