

# Asia Strategy Bulletin

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## China to take next step in capital account opening

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- China is planning to further open up its capital account by allowing more flexibility for domestic individuals to make outbound investments, as well as making China more attractive for foreign investors and issuers. The plans are still under study at financial authorities led by the State Administration of Foreign Exchange (SAFE). The timing is expected to be some time in 2021.
- This potential policy move serves two key purposes:
  - Alleviate currency appreciation pressures, while the central bank normalizes monetary policy, as noted in the PBOC's 4Q monetary policy report (MPR).
  - Facilitate multi-lateral trade and investment agreements, as well as RMB internationalization and capital market opening to make RMB a more globally accepted currency and reduce dependence on USD financing.
- Potential impact on markets
  - CNY exchange rate: The impact is likely limited, as the vast majority of FX flows in CNY is by corporates and financial institutions, while individuals' demand for outflows is limited given relatively strong economic position. As a result, CNY strength is likely to remain until the Fed turns more hawkish or when the USD bear market ends, both still some time off in our view.
  - Equities: Positive for offshore insurance and wealth management, as well as onshore brokers and insurers. But it is likely neutral in terms of overall equity flows, as mainland investors already have access to HK through the equity connect programs, and might not be significant enough for larger markets like the US. Though there may be greater preference for popular consumer brands, electric vehicles and tech names in these markets.
  - Bonds: There may be some attraction towards property bonds where yields can sometimes be higher in HK than on Mainland, depending on the credit policy cycle. But generally speaking, CNY onshore yields are more attractive and familiar to mainland investors than hard currency offshore varieties.

## What happened?

- On Feb 19, the head of SAFE capital account management department—Ye Haisheng—wrote an article in the SAFE magazine, *China Forex*. He articulated that the authorities are studying plans to take further steps to liberalise China's capital account by easing restrictions on capital outflows. He noted that 2021 is the year to push these initiatives forward.
- The big headline is the possibility of **allowing individuals to freely invest up to US\$50,000 per year in foreign assets**, without specific approval. This is especially geared towards investments in equities and insurance products to improve access to personal wealth management in foreign assets.
- But the potential plans go much further than that. The article stated that the goal is to **orderly open individual capital account and eventually eliminate annual FX conversion quotas**. In addition, he highlighted five areas of focus to attract foreign investors and issuers.
  1. **Unify FX transaction rule across all domestic markets for debt and their derivatives.** This would help to make the interbank and exchange based debt markets equally accessible to foreign institutional debt investors, who have significant need for hedging interest and exchange rate risks.
  2. **Streamline and liberalise rules for FX transaction needs of securities issuers.** This aims to attract more issuers of “panda” bonds (foreign entities issuing debt onshore), domestic equity issuance of “red chip” companies (state owned enterprises incorporated outside of China), and China Depository Receipts (CDR) and Global Depository Receipts (GDR) issuers under the Shanghai-London equity connect program. A key hurdle in advancing these three capital market programs had been the policy uncertainty related to how freely the capital raised can be converted from CNY to another currency and sent outside of China. Presumably, the new rules would help to relax these restrictions and make China a more attractive place to raise capital for global issuers.
  3. **Advance the Qualified Domestic Institutional Investor (QDII) regime**, by expanding quota distribution, increase quota, and more flexibly manage the pace and accessibility.
  4. **Allow insurers to more freely invest in foreign assets.** This would enable reasonable asset diversification needs of domestic insurance companies. This could become a meaningful flow towards offshore shares, particularly in HK.
  5. **Trials for securities brokers to engage in FX business.** Some trials have already begun and plan to expand to more brokers. Trading FX for clients is important for the brokers to be able to provide complete offshore wealth management solutions to clients. This is a clear positive for domestic brokers, but may still take time to become a meaningful contributor to revenues.

## Why are they doing this now?

- This is coming in a backdrop where the PBOC has begun to curb excess liquidity and rein in credit growth. One concern was that the policy normalization would add pressure for currency appreciation. But in its 4Q Monetary Policy Report (MPR), the PBOC noted its intention to enhance its expectation management on the RMB and issue more measures to encourage capital outflows, with the follow three takeaways:
  1. The PBOC does not plan to curb currency appreciation by lowering domestic interest rates;
  2. The PBOC wants to reduce intervention which has periodically slowed down the pace of appreciation since last Nov;
  3. Instead of the above two methods, opening the outbound side of the capital account is deemed more desirable.
- In other words, **easing restrictions to capital outflows is a follow-up to the PBOC's announced stance towards exchange rate management.**
- **A second important purpose is to facilitate multi-lateral trade and investment negotiations.** China is the key proponent and the largest member of the Regional Comprehensive Economic Partnership (RCEP), the world's largest free trade area. Yet, China admits that many aspects of its capital account controls do not match

the spirit of the RCEP. Mr. Ye also noted that clearing out these mismatching capital controls is also meant to show China's commitment to the RCEP.

- In addition, the easing controls are key to expediting China-EU mutual investment agreement, as well as China's ongoing negotiations to join the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), also known as TPP-11 after US exited TPP negotiations under President Trump. These two potential agreements would involve much more mutual investment agreements compared to the RCEP, which is more trade-centric.
- A third purpose is to **widen international acceptance of the RMB**, especially as the US-China relationship deteriorated in recent years. Indeed, reducing dependence on the USD has gained international support, since the Trump administration's tariffs, sanctions and threats to weaponise the USD spooked governments and investors well beyond China. Allowing freer exit of capital is critical for China to gain wider acceptance. Over time, a freer capital account combined with a potential international digital currency network (see *Asia Bulletin—Eight things one must know about the eCNY*, 28 January 2021) could make CNY a more viable competitor to the USD as a global hard currency.

### How should investors position for this possible policy?

- CNY exchange rate:
  1. The impact of easing outflow restrictions could increase volatility, but is unlikely to impact direction of the currency in the near term. The vast majority of FX flows in CNY is done by corporates and financial institutions, such as trade finance and dividend payments. Individuals' demand for capital outflow is more driven by the need to diversify currency holdings. At the moment, this demand is relatively benign given the economic recovery and weakening USD. Longer term prospects of China is also robust relative to US and other developed markets.
  2. Allowing easier exit of capital reflects authorities' confidence in these prospects. As a result, CNY strength is likely to remain until the relative interest rate and growth expectations change. In our view, the CNY appreciation is likely to continue until the Fed turns more hawkish, or when USD bear market is complete, which is still some time away. Until then, the PBOC may influence the pace of appreciation, but unlikely to change the direction.
- Equities:
  1. Positive for offshore insurance and wealth management. HK insurers are likely to most direct beneficiaries. In 2015, cross-border insurance purchases (often on credit cards) fuelled capital outflows, authorities clamped down on these purchases of offshore insurance products. The \$50K per year of quota is more likely to go into insurance than equities, where existing channels are already robust. Greater Bay Area wealth connect program may finally begin to take shape.
  2. Onshore brokers and insurers could also benefit if implemented. Domestic brokers could be a key beneficiary from offshore wealth and FX businesses, but this could take time to set up. Onshore insurers could benefit from asset diversification, which is positive, but still with uncertain investment results.
  3. In terms of overall equity flows, however, easing restrictions might be more neutral. Mainland investors can already access HK equities through the equity connect programs. For other markets like US, European and Japanese equities, the \$50K per year might not be significant enough to move the needle. Though there may be greater preference for popular consumer brands, electric vehicles and tech names in these markets.
- Bonds: There may be some attraction towards property bonds where yields can sometimes be higher offshore than on Mainland, depending on the credit policy cycle. But generally speaking, CNY onshore yields are more attractive and familiar to mainland investors than hard currency offshore varieties.

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