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Further Expanding the Opening Up of China's Financial Industry

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Introduction

A Communiqué of the Third Plenary Session of the 18th Central Committee of the Communist Party of China (CPC) proposed that the government should 'perfect the financial market system and expand the opening up of the financial industry both domestically and internationally'. The '13th Five-Year Plan' further clarifies the goal of 'promoting two-way opening of the financial industry'. The financial industry is essentially a competitive industry, and only full competition can improve its efficiency and vitality. International practice shows that expanding the opening of the financial industry can enhance the competitiveness of financial institutions and fundamentally prevent and defuse financial risks. Since joining the World Trade Organization (WTO) in 2001, China has made great progress in opening its financial industry. Openness of financial institutions has kept increasing, a multilevel and diversified financial market is taking shape, the degree of two-way openness is constantly expanding, and the institutional environment has improved. However, the openness of China's financial industry is still insufficient. The overall

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market share of foreign financial institutions in China is low, much lower than in major developed economies and most developing countries. There are still many discriminatory provisions in regard to the ownership ratio and business scope of foreign financial institutions. Additionally, the breadth and depth of China's financial market is insufficient and the accounting, audit and taxation systems are underdeveloped, leaving much room for improvement.

China's experience shows that opening up has promoted trade and investment liberalisation, exchange rate liberalisation, relaxation of foreign exchange control and allowed the market to play a more active role. Over the years, the troika reforms—opening of the financial industry, exchange rate liberalisation and relaxation of capital control—have made coordinated progress, creating a favourable financial environment for China's economic growth (Zhou, 2017). A problem with any of these three will affect the entire opening process. Therefore, although the pace of the three reforms may be uneven, they have been moving forward in the same direction. Other chapters discuss the exchange rate and capital flows; this chapter focuses on the opening of the financial industry.

Part 1: Theoretical basis and practical significance of further opening of the financial industry

The opening of the financial industry needs to address two important issues: whether a country should open its financial industry, and how to open it. To answer the first question, we need to have a clear understanding of the nature and position of the financial industry. If the financial industry is a competitive industry, it does not need monopolies and should not impose too many restrictions on investors. The authorities should fully promote market competition and enhance the efficiency and vitality of the financial system through further opening.

The nature and position of financial services industry

In theory, the financial service industry is essentially competitive; therefore, its vitality and competitiveness must be enhanced through competition. George Stigler, the Economics Nobel laureate, proposed three elements that a competitive industry should possess (Stigler, 1983). First, there should be a high number of enterprises within the industry, and the products of the enterprises should be similar and substitutable to a certain extent. Second, collusion among enterprises should be difficult. Third, for new enterprises wishing to enter the industry, the long-term average cost should not be significantly higher than for existing enterprises in the industry.

The financial industry conforms to the above characteristics of a competitive industry. First, there are many financial institutions and the financial services are very similar. For example, China's banking industry had 4,399 corporate financial institutions at the end of 2016 (China Banking Regulatory Commission [CBRC], 2017). Their main financial services included clearing business, credit business, financial transaction, and investment banking—homogenisation is quite apparent. Second, it is difficult for different financial institutions to influence the prices of financial services through collusion. Due to the large number of financial institutions and high similarity of financial products, consumers have greater freedom in choosing financial services and it is difficult for financial institutions to monopolise pricing. Additionally, along with the deepening of financial innovation, the barriers among banking, securities and the insurance industry are gradually being removed. Different businesses overlap and penetrate each other. The competition in financial institutions no longer originates in that industry, which further increases the difficulty of collusion. Third, natural monopoly industries such as water, power and gas often require a significant initial investment in pipelines and other infrastructure, so the sunk costs are relatively high. Many enterprises providing similar services will lead to the duplication and waste of inputs and are not conducive to efficiency improvements in the industry. However, as a service industry, the competitiveness of the financial industry is mainly embodied in the customer relationship, core technology and financial innovation. It is more dependent on limitless investments, rather than a one-off large investment. Therefore, the average operating costs of new financial institutions are not significantly higher than those for current financial institutions. Further, the innovation of products and services provided by a single financial institution also contributes to the development of the entire financial industry, along with improvements in financial efficiency, reducing duplication and waste. Thus, the financial service industry is essentially competitive, and only competition can enhance efficiency and stimulate vitality.

From the practice of China's reform and opening, the introduction of competition has effectively improved operational efficiency in the banking industry. This further confirms the financial services industry's competitive nature. During the 40 years of reform and opening, domestic banks have achieved great improvements in operating efficiency, asset quality and corporate governance through introducing external strategic investors, competitive share reform, initial public offerings and other measures. Simultaneously, more and more financial institutions have begun to 'go global'. They have participated in international competition globally; made substantial improvements in all aspects including risk management, product pricing and anti-money laundering; and have promoted the stable operation of enterprises and the healthy development of the financial market. Conversely, a lack of competition can lead to inefficient practices, resulting in high leverage, low capital, non-performing loans and other phenomena, making the system prone to financial crises. The main reason for the Asian financial crisis was the low efficiency and risk accumulation caused by the lack of competition among financial institutions over a long period.

Compared to competitive industries, the financial services industry also has its own characteristics. First, the asset liability structure of financial institutions is unique, such as the liquidity risk brought about by high leverage and maturity mismatches that are naturally formed. This makes financial institutions vulnerable to competition, which shows a certain level of fragility. Second, the day-to-day operations of financial institutions are susceptible to market sentiment, and public confidence is critical to the soundness of the financial system. Third, financial crises are highly contagious; the problems of a single financial institution may lead to a chain reaction in many financial institutions, and even endanger the stability of the whole financial system. Therefore, the security and stability of the financial industry is essential to the healthy and smooth operation of the economy. A fully competitive financial services industry is premised upon an effective allocation of resources, the basis for effective transmission of monetary policy and a guarantee for the rapid development of financial innovation. Only by building a more competitive financial service system can we effectively maintain financial stability and enable a comprehensive supporting role of finance in the real economy.

Comparison of international and Chinese experiences of opening

Opening to the outside world can promote competition. By introducing advanced management models, technologies and rules, the competitiveness and soundness of the financial system will be improved, and financial risks will be reduced. The entry of foreign financial institutions has compelled domestic financial institutions to achieve greater improvement in product design, market development, business models, management experience and other aspects. Additionally, it creates the need to reform accounting rules and regulatory standards (Zhou, 2017). Market competition can force financial institutions to focus more on key areas such as the capital adequacy ratio, leverage ratio and liquidity risks, and encourage them to guard against risks through self-discipline. Additionally, full competition can reduce the moral hazard associate with 'too big to fail' and better safeguard the bottom line of no systemic financial risks. International experiences also show that financial opening is not the cause of financial risk. On the contrary, opening can reduce and defuse financial risks.

First, expanding opening can introduce advanced management concepts, techniques and rules to promote market competition, improve market efficiency and maintain financial stability (Claessens, 2009; Yeyati & Micco, 2007). An efficient financial system is the fundamental guarantee of financial stability. Taking Turkey as an example, the entry of foreign banks had a positive spill-over effect on its financial system. During the 1980s and 1990s, foreign banks took the lead in using modern budgeting methods in Turkey. An electronic banking office system was introduced and use of the Society for Worldwide Interbank Financial Telecommunications network was pioneered. These advanced systems and technologies were subsequently adopted by many Turkish banks. Financial sector efficiency was improved, along with management standards and budget transparency.

Second, expanding opening is beneficial for risk diversification. Previous financial crises show that concentrated financial risks can have a significant impact, while dispersed risks can be defused more easily. More opening is an important method to spread risk. Opening will bring in more market players and increase competition, meaning risks will be less concentrated and borne by more market participants (Dages, Goldberg & Kinney, 2000). For example, from 1994–1999, Latin American economies were highly dependent on foreign debts, cross-border capital flows fluctuated dramatically, the governments ran long-term deficits and local currencies were seriously overvalued. As a result, serious crises broke out successively in some countries. However, foreign banks were not the trigger of these crises. Instead, they played the role of 'economic stabiliser'. Both before and after the crisis, the non-performing loan ratios of foreign banks in Argentina, Brazil and other Latin American countries were generally lower than those of domestic banks, and the pro-cyclicality and volatility of their lending were also smaller than domestic banks.

Third, a closed financial industry will lead to risk accumulation and threaten financial stability. For example, Mexico forbade foreign banks from entering the domestic market before the late 1980s. During the 1990s, the pace of opening remained slow in Mexico. In 1994, foreign bank loans in Mexico accounted for only 1 per cent of Mexico's total bank loans. Due to lack of competition, the efficiency of domestic banks was very low, risk control was inadequate, moral hazard was serious and potential non-performing loans surged. Faced with rising interest rates globally, the Mexican Government was forced to raise interest rates in 1994. As a result, the interest rate burden of enterprises was increased, loan defaults started to rise, financial risk was highlighted, investor panic grew and the Mexican peso was sold off. The Mexican Government issued large amounts of debt in dollars to maintain the exchange rate. Eventually, the government was overwhelmed by the debt burdens, the peso depreciated sharply, the default rates of bank loans rose dramatically and Mexico was plunged into a full-blown financial crisis. After the crisis, the Mexican Government drew on the lessons learned and gradually allowed foreign financial institutions to enter the domestic market to encourage competition, strengthen market discipline and reduce the risk of financial instability.

Since China joined the WTO, all those areas that have thoroughly opened and actively participated in the global allocation of resources—China's finance, commerce, agriculture, automobile and other industries—have achieved better development, strong competitiveness and high degrees of internationalisation. China has become the world's second-largest economy and the largest exporter. Opening has ushered in extensive reform in China, helped industries to meet international standards, promoted innovation of mechanisms and systems, and expanded the competitiveness and influence of many sectors. Some competitive industries, such as the home appliance industry, developed rapidly after opening. With goods such as colour televisions, refrigerators, washing machines and other large appliances, domestic brands occupy the leading position in China's market and operate as spokespeople for 'Made in China' internationally.

Conversely, industries that lag in opening are developing at a slower pace. More protection and restriction policies can only protect the weak and preserve monopolies. China started its WTO negotiations during the aftermath of the Asian financial crisis, and there were various views on financial opening and financial risks. Compared to other industries, the liberalisation of the financial industry was relatively slow. With the accomplishment of banking reforms and the continuous development of the financial market, the time was right for the financial industry to open. However, the opening process still lagged significantly due to outdated thinking and institutional inertia. After a series of reform, state-owned banks in China have improved in indicators, such as the non-performing loan ratio and capital adequacy ratios, and the four major state-owned banks now rank among the global systemically important banks (see Table 3-1). However, Chinese financial institutions still lag behind in many areas such as fund management and derivatives. The level of financial opening is becoming increasingly incompatible with the development of the real economy and the overall openness. This not only affects the financial industry's competitiveness, but also restricts the internationalisation of the RMB and the 'going global' strategy. Therefore, China needs to further open up the financial services industry, introduce more competition and provide a strong incentive for reform.

Table 3-1: Global systemically important banks (2016)

Grade (Capital requirement)	Bank
5 (3.5%)	–
4 (2.5%)	Citi Group, JP Morgan Chase
3 (2.0%)	Bank of America, BNP Paribas, Deutsche Bank, HSB
2 (1.5%)	Barclays, Credit Suisse, GoldmanSachs, Industrial and Commercial Bank of China, Mitsubishi UFJ FG, Wells Fargo
1 (1.0%)	Agricultural Bank of China, Bank of China, Bank of New York Mellon, China Construction Bank, Groupe BPCE, Credit Agricole, ING Bank, Mizuho FG, Morgan Stanley, Nordea, Royal Bank of Scotland, Banco Santander of Spain, Société Générale, Santander, State Street, Sumitomo Mitsui FG, UBS, Unicredit Group

Note: Classification is determined by the criteria set by the Basel committee.

Source: Bank for International Settlements (2016).

Further opening the financial industry meets China's own need for development

Currently, international and domestic situations have set higher demand for the opening of China's financial industry. Internationally, globalisation faces great challenges due to unbalanced technological development, low productivity growth and increased income inequality. Following Donald Trump's election as president of the United States (US), nationalism, populism and trade protectionism have increased, and an undercurrent of anti-globalisation has surged. The US and other developed economies have taken measures to enhance their competitiveness, such as bringing manufacturing industries home, offering tax cuts and deregulating the financial industry. These policies may set an example for other countries and impact the free trade system and the multilateral rules that have been formed globally over the years. As a result, the global governance system may reach a 'crossroad'. China is a rising power and a beneficiary of globalisation and the current multilateral mechanism. It needs an open and fair environment that protects international trade and investment. If protectionism continues to grow and global trade and investment fade, China's interests will suffer. Therefore, China should send a clear message that it will further open to the outside world; play a leading role in globalisation together with other major countries; ensure free movement of trade, resources, capital, technology and human resources across borders; and better safeguard its interests.

Domestically, China's economic development has entered a 'new normal'. Economic transformation and upgrading have entered a crucial period, and the foundation of financial development is undergoing profound changes. Additionally, the financial industry also has the arduous task of supporting the supply-side structural reform, and potential financial risks cannot be ignored. Therefore, China must further open the financial sector to promote reform, improve the investment environment and market condition, and enhance the soundness of the financial system. Simultaneously, China's comparative advantage is changing and enterprises have accelerated their pace of 'going global'. This places higher requirements on the depth and breadth of the financial system. However, the pace of China's financial institutions entering the global markets is lagging significantly and can barely meet the financial needs of enterprises that are 'going global' (Ministry of Commerce, 2015). Therefore, further opening of the financial sector is required, along with the acceleration of the 'going global' of financial institutions and financial services. A global network must be formed to support the real economy more effectively.

Simultaneously, the low level of openness of China's financial sector has brought criticism from the outside. Some foreign businesses believe that the improvement in China's business environment in recent years is limited and, thus, hope China will further push forward reform, opening and marketisation (American Chamber of Commerce in the People's Republic of China, 2017). For example, they hope that the government further loosens restrictions on market access and business scope for banking, securities, insurance and fund management. It is also hoped that the government increases the transparency, consistency and predictability of foreign exchange policy; treats foreign enterprises fairly; further reduces licensing barriers; strengthens the protection of intellectual property rights; and relaxes or cancels data flow restrictions. The top priority for Chinese authorities is to improve the domestic investment and market environment. One important measure is to further expand the opening of the financial sector.

Opening the financial industry: Pros and cons

First, opening the financial industry can help build a diversified financial system. Theoretically, the entry of foreign financial institutions into the Chinese market promotes competition, expands financial services channels and enhances financial stability (Clarke, Cull, Martinez Peria & Sanchez, 2001; Claessens, Demirguc-Kunt & Huizinga, 2001). Foreign banks, securities and insurance firms have brought new business models to China, which has enriched the Chinese financial system and improved its operational efficiency. China's first township bank was established by a Hong Kong financial institution (Hong Kong and Shanghai Banking Corporation), and unsecured credit loans were launched by Standard Chartered Bank in 2006. Foreign banks also had an earlier interest in green finance, financial technologies, risk pricing and other business. Their technology and concepts have provided valuable reference to Chinese financial institutions. AIA Group entered China in 1990 and brought in the sales agent model. The model was gradually adopted across the country and became an important sales channel for life insurance companies in China. The development of China's securities market also draws on the Western trading system. The trading rules of the London Stock Exchange and Hong Kong Exchanges and Clearing have become important references for the Shanghai Stock Exchange. The entry of more foreign financial institutions could produce economies of scale and attract new businesses and technologies, which helps build China into an international financial centre.

Second, opening the financial industry can better serve the real economy and push forward supply-side structural reforms. The financial sector and the real economy are closely linked and mutually reinforcing. Transformation and upgrading of China's economic structure needs to further boost domestic demand and encourage the development of small and medium-sized enterprises and high-tech enterprises. However, Chinese financial institutions have made relatively slow progress areas such as consumer credit, small and micro loans, and venture capital investment. As a result, there is only a limited number of financial products that truly serve the real economy, and speculation and arbitrage is prevalent. In contrast, foreign financial institutions have rich experience and advantages in corporate governance, credit management and risk pricing. They can serve as good examples for Chinese institutions and help optimise the economic structure.

Third, opening the financial industry can accelerate the opening of the service sector. Currently, the level of openness of China's service industry is below that of the manufacturing industry and significantly lower than the average level of other countries. The level of openness is not in proportion to the contribution of the service industry to economic growth. This has also been criticised by other countries. Presently, countries are working on more comprehensive and higher standards for opening the service industry. China needs to seize the opportunity and be more proactive. The negative impact of opening the financial sector is relatively small and controllable, and the sector is a critical area in which there are plenty of opportunities for China.

Additionally, opening the financial industry can consolidate the reserve currency status of the RMB and promote internationalisation of the RMB. Owning an international reserve currency is important to the long-term development of an economy. After becoming an international reserve currency, the RMB will enjoy institutional rights, and international recognition and attractiveness of bilateral currency swap agreements signed by the People's Bank of China and other central banks and monetary authorities will substantially increase. The RMB becoming an international reserve currency can greatly enhance confidence in the currency at home and abroad, reduce the possibility of economic and financial turmoil, and lessen the spill-over effects of other countries' policies. Simultaneously, the issuer of a reserve currency can have more independent monetary policies and more tools to deal with financial crises, and use the currency more frequently for international transactions and investment. This will enhance the pricing power and voice of the country in trade and investment. To consolidate the RMB's status as a reserve currency and promote its internationalisation, China must make the RMB more 'freely usable', expand the opening of the financial industry, and provide a friendly and convenient environment for investors to conduct RMB business both in China and overseas to enhance China's global attractiveness.

There are concerns that opening will bring risks. For example, opening the financial sector is likely to accelerate cross-border capital flows and bring risks to the country's macroeconomic and financial stability. Additionally, foreign financial institutions have complex products, have a high frequency of transactions and engage extensively in derivatives transactions. Problems in these areas may cause cross-institutional and cross-market risks through liquidity, products and asset price channels. However, with the continuous progress of reform and opening, the flexibility of RMB exchange rate has been enhanced, the convertibility of capital accounts has also made great progress, and the conditions for opening the financial industry are becoming ripe. The aforementioned risks are largely controllable for several reasons.

First, China has made great progress in strengthening financial regulation and preventing risks. In recent years, China has constantly improved the assessment, prevention and early warning of systematic financial risks as well as risk disposal mechanisms. The financial regulation system has been continuously perfected, the effectiveness of regulation has been enhanced, the framework of macroprudential regulation has been well set up, financial infrastructure has been steadily developed, and authorities' ability to guard against financial risks has significantly increased. These measures can effectively safeguard financial security.

Second, in recent years, Chinese financial institutions have rapidly increased their assets and network of branches, and acquired a high market share and a large client base. Foreign financial institutions have no obvious advantages in business scale, networks and client relations. As such, it is difficult for them to pose a threat to the development of Chinese financial institutions.

Third, China has some unique advantages that enable it to resist external shocks. China is already the world's second-largest economy, the world's largest exporter and has the largest foreign exchange reserve in the world. The size of its financial market is also significant. The balance of China's bond market ranks third in the world and second in Asia (see Figure 3-1). Additionally, China has the second-mover advantage. Many developed countries and emerging markets economies have rich experiences with financial opening that China can use as reference.

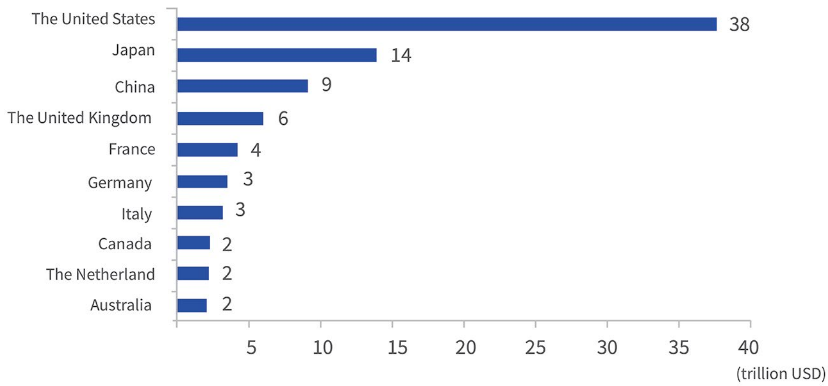


Figure 3-1: International comparison of bond market size (as of September 2016).

Source: Bank for International Settlements (2016).

There are also concerns that further opening of the financial sector might put China's financial security at risk. However, financial security should be secured by sound systems and institutions, rather than discriminatory market access policies. China should safeguard financial security through sound operation and risk management in financial institutions, effective policy tools including a prudential regulation framework, and increasingly effective and transparent financial markets. Only with sound institutions can China maintain public confidence in the financial system and safeguard the bottom line of no systemic financial risks.

Additionally, China can use the national security review mechanism to fend off threats to security, stability and integrity of the financial system. Developed countries have highly open markets where national security review is applied only to a small number of foreign investment applications. China needs to properly balance opening up and national security and use the review rationally. Investigations should be carried out with caution to avoid criticism that China implements protectionism in the name of national security.

Part 2: Progress in opening China's financial sector

In recent years, China has made great progress in opening its financial sector. The openness of financial institutions and financial markets has improved, the pace of financial institutions 'going global' has accelerated, RMB internationalisation has made remarkable achievements, and China's participation in global economic and financial governance has achieved positive results.

Financial institutions and financial markets

The openness of China's financial institutions has improved. Since joining the WTO, the opening of China's financial services industry has constantly deepened. The country launched a series of policies and measures in the banking, securities and insurance industries, and has eased restrictions on the establishment, location and business scope of foreign financial institutions based on a gradual approach. At the end of 2016, there were 39 foreign banks (including financial companies) and 121 branches of foreign banks in China. The assets of foreign banks accounted for 1.3 per cent of the total assets of banking institutions in China (CBRC, 2017). As of March 2017, there were 13 joint-venture securities companies in China, making up 10 per cent of the total securities companies and assets accounting for 4.5 per cent of total assets. At the end of 2016, there were 56 foreign property insurance companies (including wholly-owned and joint ventures) and joint-venture personal insurance companies, accounting for 30.4 per cent of the total property and personal insurance companies in China (see Figure 3-2).

In terms of the opening of the financial market, foreign investors in the bond and interbank bond markets continue to increase. As of February 2017, there were 432 foreign investors in the interbank bond market, including foreign central banks and monetary authorities, sovereign wealth funds, international financial organisations, offshore clearing banks and participating banks, foreign insurance institutions, Qualified Foreign Institutional Investors (QFIIs) and RMB Qualified Foreign Institutional Investors (RQFIIs). This represents a total investment of nearly CN¥800 billion (Zhu, 2017). The varieties of interbank bond investment have been enriched constantly, and the level of development and professionalism of the bond market has been improved. The scope of issuers of Panda bonds has also expanded to include non-financial foreign enterprises, foreign commercial banks, international development institutions and foreign governments. As of the end of 2016, a total of CN¥63.1 billion of Panda bonds were issued (Zhu, 2017). Additionally, the mainland and Hong Kong bond markets have achieved interconnection via the 'Bond Connect'. In the stock market, the Shanghai–Hong Kong Stock Connect and Shenzhen–Hong Kong Stock Connect have been launched successively, greatly improving the two-way opening of capital accounts. China's A-share market was officially included in the MSCI index, which further enhanced the degree of internationalisation.

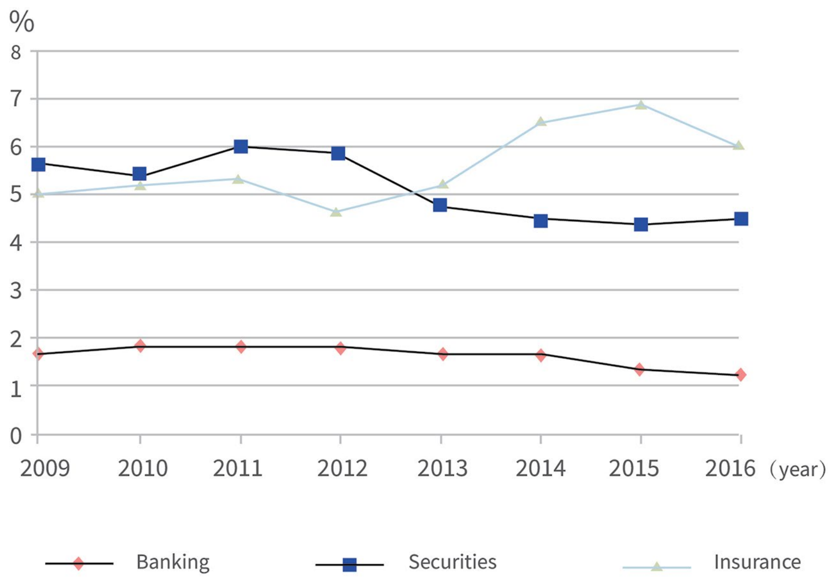


Figure 3-2: The change in proportion of assets of foreign financial institutions in banking, securities and insurance industries in recent years.

Sources: CBRC (2017), China Securities Regulatory Commission (2017) and China Insurance Regulatory Commission (2017).

RMB internationalisation

In recent years, the internationalisation of the RMB has made remarkable progress. In early 1992, China approved small amounts of RMB settlement to meet the demand of trade activities in 13 cities along the borders such as Heihe. After 2002, Vietnam and other neighbouring countries allowed their local currencies and the RMB (or only the RMB) to be used for border trade settlement, which promoted cross-border use of the currency.

In 2004, Hong Kong and Macao launched cross-border RMB business. The business grew rapidly, but the scale remained small. After the 2008 global financial crisis, major international settlement currencies such as the US dollar fluctuated sharply, and the demand for the RMB in cross-border trade settlement by Chinese and foreign enterprises rapidly rose. Given this need, the People's Bank of China conducted pilot programs on cross-border trade settlement in RMB in 2009. In recent years, bilateral currency swap, direct currency trading, RQFII, RMB clearing banks, the RMB cross-border interbank payment system and other institutional arrangements have effectively reduced the exchange rate risk and promoted trade and investment facilitation.

In 2015, the International Monetary Fund (IMF) conducted the special drawing right (SDR) review. The People's Bank of China, along with relevant departments, introduced a number of important measures in relation to opening the bond and foreign exchange markets, improving data transparency and strengthening policy communication. With these efforts, the RMB finally reached the standard of the SDR basket currency. On 30 November 2015, the Executive Board of the IMF decided to include the RMB in the SDR basket, and the IMF affirmed that the RMB was a 'freely usable currency'. The new basket became effective on 1 October 2016. The inclusion of the RMB in the SDR basket greatly increased the attractiveness of the RMB. In September and October 2016, the RMB assets held by the People's Bank of China exceeded US$10 billion. The RMB assets held by international financial organisations and multilateral development institutions and in foreign exchange reserves of various countries also increased. On 31 March 2017, the IMF released its official statistics on the currency composition of official foreign exchange reserves (COFER) in which the RMB was listed separately for the first time. As of the end of 2016, RMB reserves held by COFER-reporting countries were US$84.51 billion (about CN¥582.2 billion), accounting for 1.1 per cent of the total foreign exchange reserves of those countries and further confirming the status of the RMB as a reserve currency (see Figure 3-3).

The aforementioned reform measures also greatly promoted the convertibility of China's capital account. According to the classification of capital account transactions (a total of seven categories and 40 items) by the IMF (2016a), 37 items have achieved convertibility, basic convertibility and partial convertibility in China, accounting for 92.5 per cent of all transaction items.

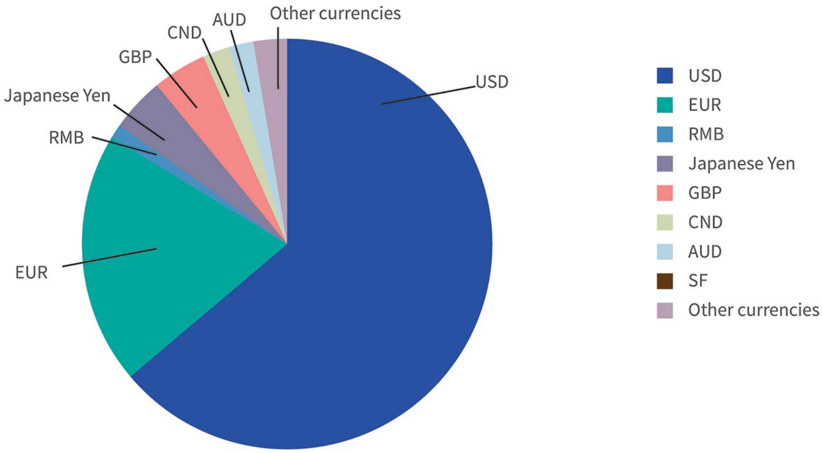


Figure 3-3: Proportion of currencies in foreign exchange reserve assets held by COFER-reporting countries.

Source: IMF (2016a).

Specifically, direct investment has achieved full convertibility, and investment facilitation has been steadily improved. China has adopted registration management for outward direct investment, and eliminated examination of the source of funds of foreign direct investment and approvals for remittance. For the overseas direct investments of banks, China also changed the regulation from administrative approval to filing. In terms of foreign direct investment, China has simplified the regulation process and placed more emphasis on regulation during and after the transactions. Simultaneously, the convertibility of cross-border financing has increased, and most items have achieved basic convertibility. All the items under external debts are also basically convertible. There is no restriction on currency exchange relating to financial credit provided by financial institutions. The proportion limit on commercial credit between residents and nonresidents has been retained, but prior control was abolished. With external debt, only a few necessary authenticity checks remain, and other administrative licensing relating to accounts and currency exchange has been cancelled. Additionally, the convertibility of securities investments has steadily increased. The control over currency exchange relating to cross-border securities trading in the secondary market is relaxed.

Part 3: Problems with China's financial opening process

China's financial industry opening has made some amazing achievements, but many problems remain. The level of openness is below international levels and insufficient to meet the need of economic development, the Belt and Road Initiative, RMB internationalisation and construction of international financial centres.

Financial institutions and financial market

Since China's accession to the WTO, foreign financial institutions have not had as strong a development momentum as expected. Conversely, the assets of foreign financial institutions have remained at a low proportion and have even decreased in recent years. Foreign banks hold around 2 per cent of China's total banking assets, which decreased to 1.29 per cent in 2016. Organisation for Economic Co-operation and Development (OECD) countries' 'average' has declined since the financial crisis but is still above 10 per cent. The average level of the other BRICS countries—Brazil, Russia, India and South Africa—soared to 15.5 per cent in 2009, substantially higher than that of China. The proportion of foreign investment in the insurance industry decreased to 5.6 per cent in 2016 after reaching a peak of 8.9 per cent in 2005; this is well below the 20–30 per cent market share in OECD countries. Additionally, change of ownership occurred in many joint-venture securities firms.

There are a number of causes for the decline of foreign financial institutions. Some multinational financial institutions were greatly affected by the 2008 financial crisis and suffered a decline of profitability. As a result, they shifted business focus to their home countries and reduced business in emerging markets. Financial regulation has also become more stringent after the crisis, cross-border operation costs have risen, and the financial institutions of some developed economies have withdrawn from emerging market economies. China's state-owned bank reform, which began in 2005, attracted a great amount of foreign investment and many foreign banks became strategic investors. With the public listing of Chinese banks, their assets continue to grow. Some foreign banks have chosen to sell the stocks and cash in to realise financial returns.

Additionally, the withdrawal of foreign banks largely reflects that China has a relatively poor environment for business operation. Although it seems that China has a high degree of openness in many sectors, foreign financial institutions in China face more policy barriers, such as restrictions on ownership percentage and business scope.

In terms of shareholding ratio, China is one of the few countries with restrictions on the proportion of foreign ownership in the banking, security and insurance sectors. From an international comparison of the 24 major economies (19 G20 countries including China, as well as Switzerland, Belgium, Luxembourg, Singapore and Chile) (see Tables 3-2, 3-3 and 3-4), most countries have lifted restrictions on the shareholding ratio of foreign and domestic capital in the banking, security and insurance sectors. Countries with requirements for shareholding ratios (the US, Canada, Australia, Mexico, Italy, South Korea and Singapore) treat domestic and foreign ownership equally and have no additional requirements for foreign investors. In some countries, the shareholding ratio is limited only for total foreign investment. For example, Russia has no limit on the shareholding of a single foreign investor; its only requirement is that the total amount of foreign investment does not exceed a certain percentage. Only India and China have discriminative shareholding ratio requirements for foreign ownership, with China's requirements being more stringent.

Table 3-2: Provisions on the proportion of foreign investment in banking sector of major economies

Country	Shareholding ratio	Specific provisions
UK, France, Germany, Switzerland, Belgium, Luxembourg, Japan, Brazil, Argentina, Chile, South Africa, Saudi Arabia	No restrictions on shareholding ratios of domestic and foreign investment.	
Canada	A limit on the proportion of shares held. However, it applies to both domestic and foreign investment.	According to Canada's broad shareholding requirements, for banks with C$12 billion or more in capital, the voting shares and the non-voting shares held by any person or co-actors should not exceed 20% and 30% respectively. For Canadian domestic banks with capital between C$2 billion and C$12 billion, the public holding of voting shares is required to reach 35%. But for those banks with capital of less than C$2 billion, there are no shareholding restrictions.

Country	Shareholding ratio	Specific provisions
Italy	A limit on the proportion of shares held. However, it applies to both domestic and foreign investment.	Domestic or foreign financial institutions cannot hold more than 15% of the shares of banking financial institutions.
Australia	Shareholding by domestic and foreign investors surpassing a certain percentage needs to pass certain regulatory procedures (such as regulatory approval).	Shareholding by a single investor (domestic or foreign) of a financial institution exceeding 15% needs to be approved by the Australian Treasury Department; the Treasury Department authorises the Australian Prudential Regulation Authority the right to approve investment of less than A$1 billion.
US	Shareholding by domestic and foreign investors surpassing a certain percentage needs to pass certain regulatory procedures (such as regulatory approval).	Any company (including foreign banks) acquiring more than 25% of the voting shares in banks or bank holding companies needs to be approved by the Federal Reserve. If a foreign bank has a branch/agent bank, a commercial loan company or subsidiary in the US, the acquisition of more than 5% of the shares of the US bank or bank holding company requires the approval of the Federal Reserve.
Korea	Shareholding by domestic and foreign investors surpassing a certain percentage needs to pass certain regulatory procedures (such as regulatory approval).	Individuals or business entities cannot own or control more than 10% of a national commercial bank's (regional banks, more than 15%) voting shares. In exceptional circumstances, a domestic individual or a business entity may hold 100% of the shares with the approval of the Finance Committee, and a financial institution established under the laws of another country that is an 'internationally recognized financial institution'[1] may owe more than 10% of the shares of commercial banks or bank holding companies established under the laws of the Republic of Korea. However, it should meet additional approval requirements of the Finance Committee.
Singapore	Shareholding by domestic and foreign investors surpassing a certain percentage needs to pass certain regulatory procedures (such as regulatory approval).	For commercial banks, if shareholding by a single or multiple shareholders in a local bank reaches 5%, approval by the Monetary Authority of Singapore is needed. For financial companies, if shareholding by a single or multiple shareholders reaches 5%, 12% or 20% of a financial company, approval by the Monetary Authority of Singapore is needed.

Country	Shareholding ratio	Specific provisions
Indonesia	Shareholding by domestic and foreign investment surpassing a certain percentage needs to pass certain regulatory procedures (such as regulatory approval).	A single domestic or foreign financial institution cannot hold more than 40% of the shares of a bank, a single domestic or foreign non-financial institution cannot hold more than 30% of the shares of a bank, and a domestic or foreign individual investor cannot hold more than 20% of a bank's shares. For shareholdings exceeding the above ratios, approval by the Indonesian central bank is needed.
Mexico	Restrictions for certain banks.	Restrictions on foreign investment in development banking institutions.
Russia	No restriction on shareholding ratio of foreign investors in any single bank. Restrictions on the proportion of foreign investment in the banking system.	The amount of a single bank's foreign investment is not limited, but the amount of foreign investment in the entire banking system is limited. All foreign investment in the Russian banking system cannot exceed 50% (excluding foreign capital entering the Russian banking system before 2007 and that went into privatisation of Russian banks after Russia's accession to the WTO).
Turkey	Restrictions on the form of establishment.	Foreign investment in Turkish banks must be in the form of a joint venture or a branch and should be approved by the Turkish Banking Authority.
India	Only restrictions on shareholding ratios of foreign investment.	In the first five years, the proportion of shares held by foreign institutions shall not exceed 50% and shall not exceed 74% later.
China	Only restrictions on shareholding ratios of foreign investment.	The proportion of the shares held by a single foreign institution shall not exceed 20%, and the proportion of total foreign investment shall not exceed 25%.

[1] According to Appendix 3 of the Free Trade Agreement between Korea and the United States, 'internationally recognized financial institutions' refers to any financial institution that obtains a rating from an international rating agency that is accepted by a Korean regulator, or that shows it has similar qualifications to Korean regulators via other means.

Source: Regulatory agencies of the countries.

Table 3-3: Provisions on the proportion of foreign investment in the insurance sector of major economies

Country	Shareholding ratio	Specific provisions
US, UK, France, Germany, Italy, Switzerland, Belgium, Luxembourg, Japan, Korea, Saudi Arabia, Brazil, Argentina, Chile, South Africa, Australia, Turkey	No limits on domestic or foreign shareholding.	
Singapore	There is a limit on the proportion of shares held. However, it applies to both domestic and foreign investment.	49% is the cap of shareholding allowed in a life insurance or non-life insurance company, and no foreign investors can be the largest shareholder.
Canada	There is a limit on the proportion of shares held. However, it applies to both domestic and foreign investment.	According to Canada's shareholding requirements, for insurance institutions with capital of more than C$2 billion, voting shares held by the public should reach 35%. But for insurance institutions with capital of less than C$2 billion, there are no shareholding restrictions.
Mexico	Shareholding by domestic and foreign investment surpassing a certain percentage needs to follow specific regulatory procedures (such as regulatory approval).	Generally, foreign ownership should not exceed 49%; if more than 49%, it must be approved by the foreign investment committee.
Russia	No restriction on foreign holding of a single insurance company. Restrictions on the proportion of foreign investment in the insurance system.	Total foreign investment in the Russian insurance system cannot exceed 50%. Foreign capital entering the Russian insurance system before 2007 and foreign capital that went into privatisation of Russian insurance companies after Russia's accession to the WTO are excluded.
Indonesia	Restrictions only on foreign shareholding.	A foreign investor cannot hold more than 80% of the shares.
India	Restrictions only on foreign shareholding.	A foreign investor cannot hold more than 49% of the shares.
China	Restrictions only on foreign shareholding.	Foreign insurance companies that set up joint-venture life insurance business with Chinese companies and enterprises cannot hold more than 50% of the total shares.

Source: Regulatory agencies of the countries.

Table 3-4: Provisions on the proportion of foreign investment in the securities sector of major economies

Country	Shareholding ratio	Specific provisions
US, UK, France, Germany, Italy, Switzerland, Belgium, Luxembourg, Japan, Korea, Singapore, South Africa, Brazil, Argentina, Chile, India, Saudi Arabia, Turkey, Australia, Canada[1]	No limits on domestic or foreign shareholding.	
Mexico	Foreign ownership exceeding certain percentage needs regulatory approval through specific regulatory procedures.	Generally, foreign shareholding of brokerage firms and bonding institutions should not exceed 49%, and if foreign shareholding of institutions that qualify stock and similar exceeds 49%, approval by the foreign investment committee is needed.
Indonesia	Restrictions for shareholding ratio by foreign investment only.	A foreign investor cannot hold more than 49% of the shares.
Russia	Restrictions for shareholding ratio by foreign investment only.	Foreign investment can only enter the securities market as a Russian legal entity. Foreign shareholding of certain types of securities market participants (securities registration company, and special depositary company with bookkeeping capacity through the traders) should not exceed 25% of registered capital.
China	Restrictions for shareholding ratio by foreign investment only.	Foreign shareholding of listed securities companies shall not exceed 25% and the proportion of that of unlisted securities companies shall not exceed 49%.

[1] Canada has no uniform rules on foreign holdings of securities companies. The Canadian provinces make their own rules based on specific needs.

Source: Regulatory agencies of the countries.

A number of historical factors contributed to the imposition of restrictions on foreign holdings of financial institutions. When the reform and opening-up policy was first launched in China, 'super-national treatment' was given to foreign financial institutions and joint ventures by some special economic zones and local governments to attract foreign investment. Preferential tax policy is one example. For example, foreign financial institutions and Sino–foreign joint ventures could enjoy a 15 per cent income tax rate if the initial investment or operating capital exceeded US$10 million and the business was in existence for over 10 years. In contrast, the income tax rate was as high as 33 per cent for Chinese financial institutions. Simultaneously, foreign financial institutions enjoyed favourable treatment in terms of tax base, turnover tax, etc. Because of this, some Chinese financial institutions wanted to 'transform' themselves into joint ventures by introducing foreign capital. According to the 'Sino–Foreign Joint Ventures Law', one requirement for a joint venture is that foreign investment should be no less than 25 per cent. Only when foreign investment reached 25 per cent could a business enjoy the preferential tax treatment.

Since China's accession to the WTO, investment policy has become more standardised. 'Super-national treatment' was gradually abolished, but the 25 per cent requirement has been retained. According to 'Measures for the Implementation of Administrative Licensing of Chinese Commercial Banks' (2003), if combined foreign holdings of a non-listed financial institution reached 25 per cent, the business would be treated as a foreign financial institution. In 2015, regulatory authorities amended the implementation measures to impose more strict restrictions on foreign ownership, stipulating that combined foreign shareholding of a Chinese financial institution should not exceed 25 per cent. This provision has substantially limited the role that foreign investors can play in corporate governance, strategic planning and financial management. Restrictions on business scope and licensing has also restricted the development of foreign-funded financial institutions.

The securities sector

Foreign securities companies can only enter China by setting up joint ventures, and can only conduct limited business such as underwriting, brokerage of foreign stocks and bonds.[6] The Chinese controlling shareholder must be a securities firm. Because a subsidiary cannot compete with its parent company, the business of joint-venture securities companies is seriously restricted. The advanced products and pricing technology of foreign companies cannot be introduced to China, which dampens foreign investors' enthusiasm for doing business in China.

6 Securities companies have seven business functions: securities brokering, securities investment consulting, financial consulting related to securities trading and investment activity, securities underwriting and sponsorship, securities dealing, securities asset management, and other securities business.

The banking sector

Branches of foreign banks need to operate in China for at least one year before they can conduct RMB business. There is no such requirement for Chinese banks. This requirement has delayed the development of foreign banks. For example, in 2011, the Silicon Valley Bank received approval to set up a joint-venture bank, SPD Silicon Valley Bank (SSVB). However, due to regulatory restrictions, SSVB could only conduct foreign exchange business until 2015 when it was allowed to engage in RMB business. As the bank's major customers are small and medium-sized technology start-ups that do not have much demand for foreign exchange, SSVB did not experience much growth in China. In 2011, SSVB also entered the UK market and was allowed to conduct pound business immediately. The bank has since provided professional financial services to many British small and medium-sized enterprises, especially technology companies. Even though the operating requirement has been reduced from three years to one year in China, this restriction is still a major impediment to foreign banks at their initial stage of development in China.

Foreign banks that intend to establish branches in China must have significant amounts of assets. Foreign banks establishing subsidiaries and joint-venture banks in China must have total assets of no less than US$10 billion the year before application. Foreign banks that intend to set up branches in China must have no less than US$20 billion.[7] Neighbouring countries and countries along the 'Belt and Road' find it difficult to meet such requirements. International experience shows that most countries do not have requirements regarding total assets for foreign banks intending to establish subsidiaries or branches; rather, emphasis is given to regulatory and compliance factors.

In terms of the number of licences, even big foreign banks can only acquire up to two licences each year, and the two licences are usually for different regions. Although this approach has been gradually abolished, foreign banks are no longer enthusiastic about investing in China. Therefore, China has missed the best opportunity to attract foreign banks.

7 The total asset requirement was abolished in October 2019.

The insurance sector

The regulator has been slow to approve the establishment of branches of foreign insurance companies in China. Fewer than two new licences are granted each year for qualified joint-venture life insurance companies. Strict licence approvals and the small quota have distorted the business plans of foreign insurance companies and restricted their ability to serve the Chinese market.

An international comparison shows that the openness of China's financial industry is still low. According to the Services Trade Restrictiveness Index (STRI),[8] as of 2016, Latvia's banking industry had the highest degree of openness (0.12), while China's banking industry ranked 41st among the 44 countries surveyed (including all the OECD countries and nine emerging economies[9]) with an STRI of 0.41, just above Brazil, India and Indonesia (OECD, 2016a) (see Figure 3-4). The STRI of China's insurance industry was 0.46 (Korea had the highest degree of openness at 0.11), ranking 42nd among the 44 countries surveyed, only above India and Indonesia (OECD, 2016b) (see Figure 3-5).

Simultaneously, the depth of China's financial market is insufficient. The opening of the securities markets is not conducted in a systemic manner, but via a 'channelised' mode, whereby foreign institutional investors invest in the domestic market through QFII and RQFII schemes, domestic institutional investors invest in the international market through QDII and RQDII, and domestic individual investors invest abroad through the Shanghai–Hong Kong Stock Connect and Shenzhen–Hong Kong Stock Connect. But outside these channels, the domestic market is disconnected from the international market. The 'channelised' opening mode is a very primitive approach with heavy administrative intervention and a low degree of openness.

8 The STRI measures market access, competition and regulatory transparency and represents the degree of openness. The higher the STRI, the lower the degree of openness.

9 The nine emerging economies are Brazil, China, Colombia, Costa Rica, India, Indonesia, Lithuania, Russia and South Africa.

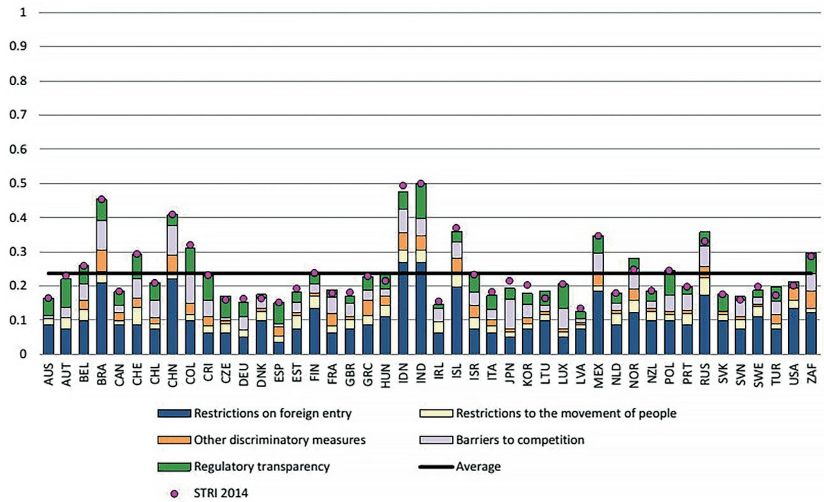


Figure 3-4: Degree of openness of the banking sector (2016).

Note: Blue represents foreign capital restrictions, yellow represents labour mobility restrictions, orange represents other discriminatory measures, purple represents competition restrictions, green represents regulatory transparency, the black horizontal line represents the average, and the purple dot represents data in 2014.

Source: OECD (2016a).

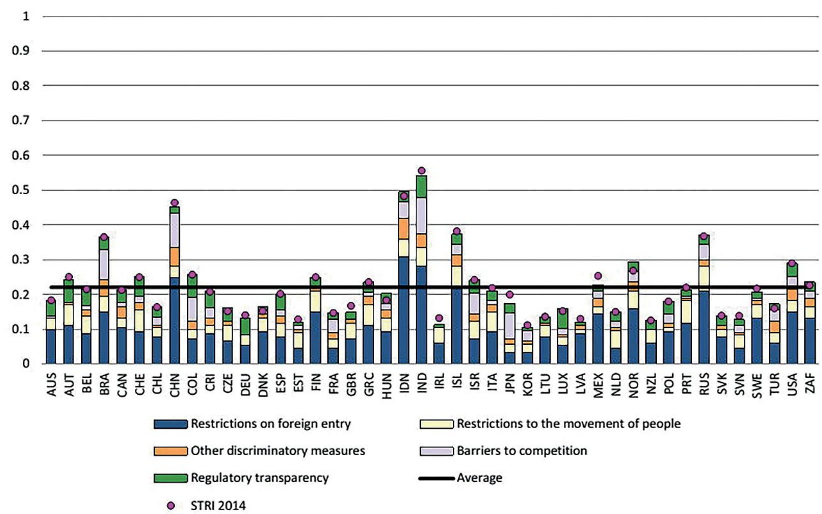


Figure 3-5: Degree of openness of the insurance sector (2016).

Note: Blue represents foreign capital restrictions, yellow represents labour mobility restrictions, orange represents other discriminatory measures, purple represents competition restrictions, green represents regulatory transparency, the black horizontal line represents average, and the purple dot represents data in 2014.

Source: OECD (2016b).

Bond market convenience has yet to be improved; some of the provisions and procedures are tedious, opaque and unfriendly to market participants. First, foreign investors cannot transfer their positions among different accounts (such as QFII account, RQFII account and interbank bond market investment account), which affects the efficiency of use of their funds. Second, investors in China's interbank bond market are required to open accounts with the central custody institution, while internationally investors can open accounts with custody institutions at various levels, which offers higher efficiency, lower transaction costs, flexible market-based transactions, and convenient and efficient clearing. Third, foreign institutions can participate in bond underwriting, but cannot be the lead underwriter. This has caused the business of foreign institutions to shrink, making it more difficult for them to meet the business qualification requirements and compete with domestic financial institutions. Fourth, non-central bank foreign investors can only sign the NAFMII (National Association of Financial Market Institutional Investors) Derivative Master Agreement, which differs from the commonly used ISDA Agreement and increases the legal costs of foreign investors. Fifth, the exchange bond market is more blocked than the interbank bond market, with a lower level of openness. Currently foreign investors can only invest in the exchange market through the QFII and RQFII channels.

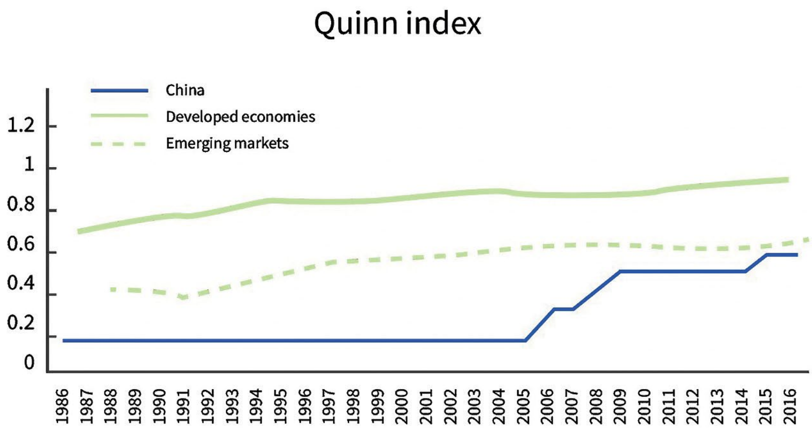
Additionally, China's accounting, auditing and taxation systems are not yet aligned with international standards (discussed at length in Chapter 5).

Convertibility of the capital account

Despite significant progresses in China's capital account liberalisation in recent years, openness remains low compared to developed economies and many emerging market economies. An international comparison shows that China's capital account convertibility is low among the G20 countries. According to IMF's measure of capital account convertibility based on the countries' capital control provisions, China's capital account convertibility is ranked the second lowest, only higher than that of India.[10]

10 The compilation of capital account convertibility is based on the IMF's (2016a) 'Annual report on exchange arrangements and exchange restrictions'. This was prepared by authorities in each country, describing in detail the seven categories and 40 items of the capital account. Based on the report, the number of convertible items or the weighted average index can be calculated, such as the Chinn-Ito index and Quinn index. The Chinn-Ito index focuses on whether there are multiple exchange rates, whether the current account and the capital account are regulated, and whether there are controls on remittance of funds. The Quinn index not only measures the presence of controls, but also assesses the degrees of regulations.

The Chinn-Ito index, Quinn index and other indices of capital account convertibility have shown that the convertibility of China's capital accounts is not only far below that of the major developed economies, but also lower than the average level of emerging market economies (see Figure 3-6). Some indices focused on laws and regulations and may underestimate the actual degree of convertibility; however, there is much China could do to improve capital account convertibility.



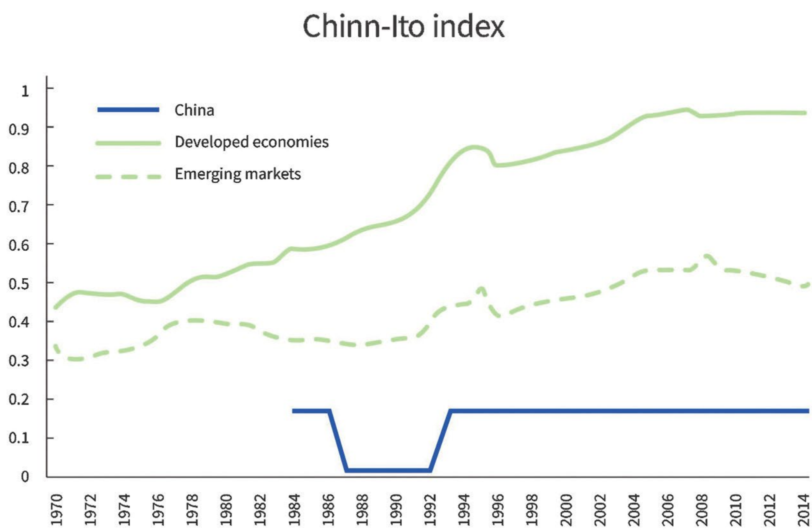


Figure 3-6: International comparison of capital account convertibility.
Source: IMF (2016a).

Part 4: Proposals on further opening the financial sector

China should consider both national conditions and international best practices; proactively expand the opening of its financial sector; adopt a more transparent approach that aligns with international practices; treat domestic and foreign financial institutions equally; and improve regulatory rules, accounting standards and other systems.

Principles for opening the financial sector

Principle I: continue to promote the 'troika'—opening the financial sector, improving the exchange rate regime and reducing capital controls—in a coordinated fashion.

China is already deeply integrated into the global economic and financial system. China should continue to push forward the opening of the financial sector, market-oriented reform of the exchange rate regime and liberalisation of capital controls in a coordinated manner. Expanding financial opening will help China better use both domestic and international markets and resources, optimise resource allocation and enhance the competitiveness of the financial system. Improving the exchange rate mechanism could enable the authorities to better regulate cross-border capital flows and enhance macroeconomic flexibility. Reducing capital controls helps stabilise market expectations and attract more foreign capital. Coordinated progress of the troika provides momentum for China's sustained and healthy development.

Principle II: opening the financial sector with pre-established national treatment and the negative list system as the core approach.

The financial industry is a competitive industry and should operate on market principles. Financial institutions should be allowed to make their own decisions and innovate. In terms of market access, competitive industries usually implement the negative list system, which allows market players to equally enter all the areas not specified in the list. This system helps all types of market players to form clear expectations and ensures that they compete fairly.

The implementation of pre-established national treatment and the negative list has become common practice internationally, and China has made it clear it will also adopt the approach. Currently, more than 100 countries employ this model including many developing and emerging market economies. China is the only BRICS country and one of only two G20 countries (the other being Saudi Arabia) that has not implemented this model. The third plenary session of the 18th CPC Central Committee decided to explore the use of this approach under which China has conducted negotiations on the Sino–US bilateral investment agreement and Sino–Europe bilateral investment agreement. Free trade zones in Shanghai, Guangdong, Tianjin and Fujian are applying the model that will be applied nationwide in the future. The negative list approach is in line with China's financial reform and opening policy and will facilitate China to better participate in global economic and financial governance.

Currently, the negative list of the financial industry is rather long (The State Council, 2017). Therefore, the primary task is to shorten the list and replace market access restrictions with prudential supervision. The negative list still contains restrictions on shareholding percentage, shareholder qualifications and business scope of foreign financial institutions (The State Council, 2017). These discriminatory restrictions reduce the enthusiasm of foreign investors and make it difficult for them to leverage advantages in corporate governance, credit management and risk pricing. Therefore, China should shorten the negative list, eliminate unreasonable access and qualification restrictions, and carry out prudential regulation to provide proper incentives to foreign financial institutions and enhance the competitiveness of Chinese financial institutions.

Principle III: promote opening of the financial sector in an orderly manner and effectively prevent risks.

Over the past four decades, the overall openness of China's financial sector has been low. One reason is that there were varied opinions over the relationship between financial crises and the admission of foreign financial institutions when China negotiated its WTO accession. Thus, while other industries have greatly increased their level of openness, the financial sector has opened slowly. It is relatively easy to control risks when openness is low. However, the situation has changed, and China needs to learn how to effectively control risks while further opening the financial sector. This requires China to strengthen financial regulation;

draw lessons from global regulators; and improve capital, behaviour and functional regulation to ensure that its regulatory capability is compatible with the level of openness.

Generally speaking, in the short term, equal treatment of foreign and domestic financial institutions should be applied to remove restrictions on the equity cap, form of incorporation and business scope of foreign financial institutions. Regarding custody model and underwriting qualifications, the standards and requirements that are unfriendly to foreign investors should be re-examined. Additionally, accounting and auditing standards need to align with international standards to facilitate overseas investors. In the medium to long term, China should pay more attention to market cultivation and product innovation; develop an open and inclusive financial market that is in line with international standards; and create a fair, transparent and predictable business and legal environment. Simultaneously, China should further promote RMB internationalisation and achieve capital account convertibility in an orderly fashion.

In the short term, China should remove policy constraints and release the vitality of financial institutions and the financial market

Equal treatment of foreign and domestic financial institutions should be applied to remove restrictions on the equity cap, form of incorporation, business scope and number of licences of foreign financial institutions to create a fair and equitable environment for foreign institutions. The following are recommended:

- Apply equal treatment of domestic and foreign financial institutions; reduce restrictions on foreign ownership of banking, securities and insurance firms; and allow wholly foreign-owned securities companies and life insurance companies.
- Further action could include eliminating the requirement on the total assets of shareholders of foreign banks, the minimum years of operation for foreign banks to conduct RMB business, and the requirement that at least one Chinese shareholder of a joint-venture securities companies must be a securities firm.

- Do not limit the number of licences granted to joint-venture life insurance companies. Grant regional operation licences to wholly-owned foreign life insurance companies and speed up the issuance of licences to facilitate the business of those institutions.

Regarding the bond market, the following are suggested:

- Streamline the transfer process between various bond accounts to improve the efficiency of fund utilisation.
- Introduce multi-tiered custody and gear up to international practice, establishing a multi-tiered custody model and a nominal holder account.
- Give foreign banks special treatment in granting some business licences based on their overall capability and scale, including their global networks and expertise in specific products and business areas.
- Align with international standards and allow foreign investors to independently choose between the NAFMII and ISDA master agreements.

Chapter 6 contains recommendations for financial infrastructure and institutions.

In the medium term, China should improve the institutional environment and promote deep integration of domestic and foreign capital markets

In terms of the stock market, China should improve the Shanghai–Hong Kong Stock Connect and Shenzhen–Hong Kong Stock Connect and explore connecting domestic and foreign capital markets via the Shanghai–London Stock Connect and Shanghai–Singapore Stock Connect to achieve full opening of the market. This will help mobilise global capital to serve China's economy, expand the investor base, attract more experienced and professional institutional investors that are committed to long-term investment, reduce market disturbance caused by the great number of retail investors and curb speculation.

In terms of taxation, China should clarify tax rules relating to foreign institutional investors in the interbank bond market as soon as possible. Preferential policies should be adopted at certain times to bring down tax rates to relatively low levels globally to attract more foreign institutions to invest in China's market.

In the medium to long term, China should further promote RMB internationalisation and achieve convertibility of the capital account in an orderly manner

The inclusion of the RMB in the SDR has brought China many practical benefits. China should seize the opportunity to strengthen the RMB's status as an international reserve currency and further promote its internationalisation. The following are recommended:

- Consolidate the RMB's status in the payment and denomination of international trade and finance; support the international reserve function of the RMB; promote the use of the RMB in the pricing and settlement of large commodity transactions; raise the degree of convenience of cross-border RMB payment of non-bank payment institutions; support cross-border, e-commerce, RMB-denominated settlement; and fully liberalise the personal current account cross-border RMB settlement business.
- Promote the development of markets for direct exchange of the RMB and other currencies to support cross-border RMB settlement business, continue currency cooperation with the monetary authorities of other countries, and support the inclusion of the RMB in the reserves of foreign central banks.
- Support the healthy development of offshore RMB markets, expand the channels for offshore RMB to flow back, and establish a virtuous circle between the two markets.

Achieve capital account convertibility in an orderly manner

At present, China is not far from achieving capital account convertibility. The following three reforms are vital (Zhou, 2015). First, relax the control on overseas investment of domestic individual investors and introduce Qualified Domestic Individual Investor (QDII2) scheme. Second, amend the 'Foreign Exchange Management Regulations' based on the 'negative list + national treatment' approach. Third, while pushing forward a registration-based initial public offering system, allow a small number of high-quality foreign companies to issue shares in China based on existing policy and domestic market situations. A great deal of preparation has already been conducted for these reforms, and relevant programs have been carefully designed. China should introduce the reform measures at an appropriate time.

Use comprehensive measures to better deal with capital flow shocks

The IMF (2016b) pointed out that countries should mainly rely on macroeconomic policies to cope with cross-border capital flow shocks. This can include increasing the flexibility of the exchange rates, curbing excessive fluctuations in the foreign exchange market, adjusting monetary and fiscal policies, establishing a more inclusive financial system, developing deep and well-regulated financial markets, and avoiding the use of capital control measures. Therefore, China should accelerate the pace of domestic reform, further improve the macroeconomic policy framework, and improve the resilience of the economic and financial system against capital flow shocks. Simultaneously, China should accelerate the reform of state-owned enterprises, reduce the distortion of price signals caused by soft budget constraints, improve the efficiency of resource allocation and enhance financial system soundness.

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