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Promoting China's Financial Market Reform and Innovation with Opening Policies

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Reform and opening are mutually reinforcing. Reform inevitably requires opening and vice versa. Opening consists of two levels. The first is to attract foreign institutions and encourage domestic institutions to go overseas. The second is to develop domestic financial markets based on the development pattern of mature financial markets and adapt to international market rules and practices. This will ensure ultimate integration with the international financial market. The second level is actually a higher level of openness. China's financial market was established and developed after reform and opening was launched in 1978. Adhering to a market-oriented development philosophy and international patterns are the drivers for China's financial market prosperity. The first level of opening will not be successful without the second. And promoting the first level will propel the second level.

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As China's four decades of practice shows, the development of financial markets is faster when the development patterns of advanced financial markets and international rules are followed. Without these, development will be problematic and may reverse. Over the past four decades, China's financial market has grown from humble beginnings to achieve remarkable growth. This shows that China can only integrate with the international market through an understanding of the country's practical needs. With the continuous expansion and deepening of China's markets, the importance of opening is increasing—opening has become an indispensable part of reform.

Currently, it is particularly important to institute reform and open China's financial market. Only an open financial market can possess real breadth and depth. Such a financial system can form effective price signals, attract more capital and investors, and support development of the real economy. China has almost completely integrated into the global economy. The country also requires a stable and open financial market at every stage of development in order to fully integrate into the international financial market.

China is committed to becoming an advanced economy. This requires China to resolve structural problems in its financial market and establish an advanced financial system that matches its global status and supports sustainable development of the real economy. This financial system must be all-encompassing, well structured, efficient, stable, inclusive and competitive. To this end, China should promote reform and development through opening, respect and abide by the rules and norms of the international market, emphasise top-level design and policy coordination, and strengthen macroprudential regulation. On this basis, China should aim to open further and establish a healthy development pattern that pushes forward both domestic reform and liberalisation.

Part 1: Key drivers of China's financial market development

To construct a socialist market economy, China's financial market began from nothing after the reform and opening launched in 1978. China has since achieved remarkable success. It has formed a comprehensive multilevel financial system that covers the money, bond, stock, insurance, gold, foreign exchange and derivatives markets. As of the end of March 2017, bonds in custody amounted to CN¥65.9 trillion, ranking third globally and second in Asia. The amount of outstanding corporate bonds is the second largest globally and the largest in Asia. The interbank bond market has a complete series of products and diversified trading tools. It has become the main element of China's bond market, and perhaps its entire financial market. As of the end of 2016, the Shanghai and Shenzhen stock exchanges listed a combined total of 3,052 companies. Of these companies, A-share stocks numbered 3,034, with a total market value of CN¥55.68 trillion. According to statistics from the World Federation of Exchanges, the total market capitalisation of China's stock market in 2015 was second only to that of the United States (US).

China's financial market takes a different development path from developed countries

The development of China's financial market has been a successful process of promoting reform and development through opening. This opening process largely followed international financial market development patterns. Initially, China made some ineffective decisions and did not follow international patterns. The country encountered some problems and had to begin again. To analyse the current situation more effectively and determine the future prospects of China's financial market development, it is necessary to understand the history of China's financial market. Lessons can then be drawn from its experiences and mistakes.

Over hundreds of years, the financial markets of developed countries have encountered various problems and experienced both crises and improvements. In the US, the *Glass–Steagall Act* (introduced after the Great Depression in 1930) separated investment banking business from commercial banking in a strict sense. In the 1980s, the US passed the *Financial Institutions Reform, Recovery, and Enforcement Act* in response to the savings and loan crisis. The *Sarbanes–Oxley Act* was passed in the 1990s after the Enron scandal to strengthen corporate governance and audit standards and improve accounting guidelines. At the turn of this century, the rollout of the *Gramm–Leach–Bliley Act* marked the US financial industry's entry into an era of mixed operation. The *Dodd–Frank Wall Street Reform and Consumer Protection Act* was introduced after the 2008 global financial crisis to control systematic risks. History shows that US financial market legislation always follows crises or problems. The regulatory authorities analysed the causes of problems and then improved regulation at the legislative and institutional level.

China's financial market has taken a different development path from that of more mature countries and, therefore, it has its own characteristics. First, China started its development late. Only four decades have passed since the launch of economic reform in 1978. Second, the development is government led. China did not follow the steps of financial market evolution in other countries, instead following the requirements of its own economic and financial development. Third, the financial market is focused on serving the government's economic agenda. The Chinese Government was short of capital at the beginning of the reform and opening. When the government tried to issue bonds, this could only be done through compulsive apportionment. In the early 1990s, when the government attempted to reform state-owned enterprises, the Shanghai and Shenzhen stock exchanges were established to support the reform. Fourth, the development of China's financial market differs from its economic reform. Economic reform began outside the system. It was driven by the market and then expanded to other areas. However, China's financial market has taken a few wrong turns while serving the government's economic needs.

China's financial market was established in the absence of a sound credit system. According to economist Richard Hicks, the commercial prosperity of Western countries relies on three factors—currency, law and credit. In the early days of China's reform and opening, only collective credit, rather than individual credit, existed. Departments with more power had more creditworthiness. However, the development of financial markets must be built on individual credit, or significant problems will result. Notably, collective credit also played a vital role in the transition from a planned to a market economy. During this process, the individual credit system had not yet been fully established. With the continued development of accounting, credit reporting, credit rating and other systems in recent years, the individual credit system is gradually progressing, creating beneficial conditions for financial market development. Many problems arising in today's financial market are connected to deficiencies in individual credit and related supporting systems, such as accounting, auditing and rating.

Respecting market law is the key to financial market development

A review of some cases in China's financial market development history clearly shows that this development would have been more rapid if common patterns and international rules had been followed. Without these elements, the development process can encounter severe problems or even fail. When China's bond market was first established, the original intention of issuing bonds was to support the reform of state-owned enterprises. Some mistakes were made that led to major risk events in the 1980s and 1990s. In the 1980s, government bonds were administratively apportioned, and a unified national bond market had not yet been established. At that time, market prices and transaction prices of government bonds varied in different places. The Wuhan exchange and repurchase transactions in Tianjin both witnessed major risks. In terms of corporate bonds, the earliest issuers were enterprises affected by ineffective management and a lack of capital and needed guarantee by banks. This kind of bond issuance is not based on enterprises' creditworthiness, and the pricing was not market-oriented but administrated pricing, which clearly contrasts with the bond markets of developed countries. The earliest issuances of corporate bonds were conducted over bank counters. If a company defaulted, bondholders would ask banks for repayment even though such requests were unreasonable.

A typical case was the 'March 27 government bond futures incident' in 1996 before the 1997 Asian financial crisis. Wanguo Securities's investment in futures led to the company's collapse. It was the largest bond company at that time. The incident showed that the rollout of financial products did not fully consider market conditions or take a gradual approach. Rather, it was based on the arbitrary decisions of regulatory authorities. Several reasons lie behind the incident. First, China's interest rate was not market based. Second, the discount rates stipulated by the Ministry of Finance were not transparent. Third, the securities exchanges lacked an understanding of the risks related to bond futures. In short, the market was not ready for bond futures.

Such incidents drove the Chinese Government to develop a more unified, healthy and transparent market. In 1997, the State Council approved the establishment of the interbank bond market. The government paid more attention to experiences from the international market and followed the rules of market development. China's domestic bond market was dominated by natural persons and characterised by collective deal-making. Per the government's aim, the interbank bond market consisted mainly of institutional investors and that engage in over-the-counter transactions, and the market emphasised financial reporting, information disclosure, credit rating and other disciplinary mechanisms. In the past two decades, the market has developed rapidly and is now the world's third largest.

China's bond market achieves development through deepening reforms

The development of China's bond market is generally driven by social needs, not administrative authorities or ideologues. Progress was made through deepening reforms, not administrative intervention. The experience over the past two decades shows that a time of great challenges is usually the best time for reform. Only in difficult times can people reach consensus on reform more easily. The real solution is to deepen reform, rather than to step back—this is an important lesson drawn from the practice of China's bond market development.

First, if the bond market is to evolve to a higher level, it must adhere to a market-oriented direction. Administrative approval or other types of restrictions should not be imposed. Reducing administrative approval procedures does not mean relaxing market regulation. Instead, issuing corporate bonds strengthens, rather than relaxes, discipline on enterprises. In the past, companies only obtained loans from banks, but now they can have multiple investors. Historically, companies could default on debt, but now they cannot operate without good credit. If a company defaults on its debt, it will be difficult for the company to issue new bonds. If an issuer releases false information, investors may sell their bonds immediately and the issuer may not find new investors. While reducing administrative approvals, the government should also strengthen market regulation—these can be achieved simultaneously. An important lesson for the development of the bond market is to reduce implicit guarantee of repayment by the government. In the past, whoever approved bond issuance had to bear the risks. Later, the regulators began to exercise control and essentially stopped approving new issuance. No approval means no risk. However, other problems arose. Companies could not raise capital from the financial market. To address the underdevelopment of direct financing in China, the PBC established the National Association of Financial Market Institutional Investors (NAFMII) in 2007. The aim was to promote the development of corporate credit bonds using market forces. The direction of development was to strengthen market discipline while reducing administrative approvals. Such market constraints include information disclosure, auditing of financial statements and various arrangements for bond custody and clearing.

Second, a significant breakthrough in the past 10 years is the development of institutional investors. Individual investors can invest in bonds through funds, asset management products offered by banks and other institutional investors. Institutional investors can manage their risks more effectively and obtain higher returns. Institutional investors can identify the risks of financial products and bond products in a more professional manner than can most retail investors. The easiest way for retail investors to invest is to purchase government bonds at banks, but these rarely achieve high returns. With the help of institutional investors, consumer savings can be channelled to the interbank bond market through a wide range of products. The bond market can achieve faster development and retail investors who lack knowledge about the bond market can avoid being cheated. As bond investors are mostly institutional investors, the bond market differs from the stock market in the custody, trading, clearing and settlement approaches.

Third, bond market development should comply with and serve the diversified needs for investment and financing of the real economy. Although China's bond market has a great number of products, it still falls short of the needs of the real economy. To meet these needs, new types of corporate credit bonds have been rolled out, including capital supplement bonds for the banks along with credit and asset-backed bonds. These products are not innovation for innovation's sake; they have been introduced to meet the needs of the real economy and to improve the financial market's ability to serve the real economy. This is also a major difference between China's bond market and some Western bond markets.

Additionally, in the interbank bond market the government has minimal influence. More intermediaries and self-regulatory organisations have been empowered to take on more important roles. For example, NAFMII was established in the banking industry and bond market in 2007. NAFMII currently has more than 3,000 members. Some important financial products are not developed by the PBC or other regulators, but by market participants. All market participants meet with lawyers and accountants to discuss proposals of new products. After balancing all interests and conflicts and assessing the risks, the design and rules of the product will be developed and registered with the regulators. Regulators mainly review the procedures of product development and the new product's compliance with risk control regulations. Regulators will also check whether the product proposal reflects a consensus among all market players. Market forces play an increasingly important role in innovation. There is no administrative approval during the registration process, only issuers and investors are involved. Issuers require more convenient financing, investors require more secure protection, and a balance between the various interests will be reached in the end. Such a products design process is more sophisticated and mature than one led by government officials. This is also an important factor that led to the success of the Chinese bond market. China should continue in this direction and aim for greater innovation in bond products.

Overall, China's bond market has basically followed the development patterns of the world's major bond markets over the past 30 years. This is why China has achieved substantial progress. Despite these achievements, China's financial market has prominent structural problems compared to the markets in developed economies. To develop its financial market further, China must promote reform and development continuously through opening, while also adhering to the market-oriented philosophy and development patterns of international financial markets.

Part 2: Assessing the opening of the major financial submarkets

China's financial market does not have a long history and neither does the opening process. The bond and foreign exchange markets were opened up relatively late (in 2005 and 2004 respectively). Although the stock market opened up first (in the early 1990s), the degree of its openness was quite limited and the primary market remains closed. Although the bond market has had a higher degree of openness, it is still well below the level of openness of the bond markets in developed countries. This part summarises the openness of the bond, stock and foreign exchange markets and analyses problems in the opening process of each market.

The bond market

China's bond market began to open in 2005, when international development institutions such as the International Finance Corporation and the Asian Development Bank were approved to issue RMB bonds in the interbank bond market. The Pan Asia Fund and Asian Debt Fund were also allowed to invest in the interbank bond market.

After the 2008 global financial crisis, the USD and other major currencies experienced drastic fluctuations. To reduce exchange rate risks, there was an increasing demand from domestic and foreign enterprises to use the RMB for cross-border trade settlement. In this context, cross-border RMB business began to thrive. The rapid development of cross-border RMB settlement created a need to invest offshore RMB back into China. In 2010, the PBC allowed foreign central banks and monetary authorities, RMB clearing banks in Hong Kong and Macao, and foreign participating banks to invest in China's interbank bond market. When these institutions were approved to invest, they were able to engage in interbank market bond business, but within a certain limit. With the development of cross-border RMB business, the scope of overseas institutions that are allowed to invest gradually expanded to include sovereign wealth funds; international financial institutions; RMB clearing banks in regions other than Hong Kong and Macao; and insurance companies in Hong Kong, Taiwan and Singapore.

Since 2013, as the scope of RMB cross-border business and international use gradually expanded, the RMB's international status rose significantly. The bond market opened at a quicker rate and adopted a more market-oriented approach.

In terms of bond issuance, international development institutions, overseas non-financial enterprises, financial institutions, foreign governments and issuers have issued RMB bonds in the interbank bond market. In 2013, Daimler issued CN¥5-billion worth of RMB bonds in China, demonstrating that foreign non-financial institutions could raise money with RMB bonds. In 2015, the Hong Kong and Shanghai Banking Corporation Limited and the Bank of China (Hong Kong) Limited were allowed to issue RMB bonds in the interbank bond market, a first-time issuance by international commercial banks following international development institutions and foreign non-financial enterprises. In 2015, Canada's British Columbia and South Korea completed registration for

CN¥9 billion of RMB bonds. In 2016, the World Bank issued special drawing right (SDR)–denominated bonds of CN¥500 million. This is strategically significant for expanding SDR use, promoting RMB internationalisation, and opening China's financial market. At the end of April 2017, foreign issuers of all types had issued a total of CN¥7.81 billion of RMB bonds. Domestic institutions issuing bonds overseas are also making progress.

Regarding investment, the scope of foreign institutions and variety of products in the domestic bond market are expanding constantly, and management is becoming more market oriented. The Qualified Foreign Institutional Investor (QFII) and RMB Qualified Foreign Institutional Investor (RQFII) schemes allowed foreign investors to conduct spot transactions in the interbank bond market in 2013. In 2015, policies were introduced to facilitate overseas banking institutions' entry into the interbank market. The entry process was simplified to a filing system; the investment cap was lifted; and the investment scope was extended to include spot transaction, bond repurchase, bond lending and bond forwards, interest rate swaps, forward rate agreements and other business approved by the PBC. In 2016, the PBC issued Notice No. 3, allowing all types of financial institutions registered legally overseas and long-term institutional investors such as pension funds to invest in the interbank bond market through the filing system. The notice also allowed issuers to decide on the size of their investment independently. Currently, the secondary interbank bond market has been opened completely to qualified foreign investors. And the same standards are applied to domestic and foreign institutions. As long as they have the proper licences and their products fulfil all requirements, they can enter the interbank bond market through the filing system without approval from administrative departments. Moreover, there are no quotas on a single foreign institution or on the total investment of all foreign institutions. The size of investment is decided entirely by foreign institutions themselves, and the PBC implements only macroprudential management. Additionally, no restriction exists regarding the source of RMB funds for foreign institutions to invest in the interbank bond market. They can be derived from RMB cross-border business, or the onshore or offshore foreign exchange markets. However, if foreign institutions want to obtain RMB from the onshore foreign exchange market, they must follow foreign exchange regulations regarding remittance, repatriation, purchase and settlement procedures. Currently, there are about 480 foreign investors in the market, with a total investment of over CN¥800 billion.

As China's bond market continues to open, major bond indices across the world have begun to consider including the Chinese market in their coverage. In March 2017, Bloomberg launched two new hybrid, fixed income indices that include RMB-denominated China bonds and global indices: the Global Aggregate + China Index, which combines the Global Aggregate Index with the treasury and policy bank bond component of the China Aggregate Index; and the EM (Emerging Market) Local Currency Government + China Index, which combines the EM Local Currency Government Index and the treasury bond component of the China Aggregate Index. Earlier, in 2004, Bloomberg had introduced the China Aggregate Index, which included China's onshore bonds, but the aforementioned hybrid indices were the first time that onshore RMB bonds were included in Bloomberg's global indices offering. Citigroup later announced that China's onshore bonds were qualified to enter its emerging markets and regional government bond indices, including the Emerging Markets Government Bond Index (EMGBI), Asian Government Bond Index (AGBI) and the Asia Pacific Government Bond Index. Citigroup also announced that if Chinese bonds continued to meet the necessary criteria over the next three months, Citigroup would eventually include China in the three indices (i.e. by February 2018) and introduce EMGBI-Capped and AGBI-Capped due to the large size of the Chinese market, with Chinese bonds weighing up to 10 per cent and 20 per cent respectively. According to Goldman Sachs, if Chinese bonds were included in all three major global bond indices (Citigroup, JP Morgan Chase and Barclays), the ratio of foreign holdings would increase from about 4 per cent at present to about 15 per cent, and US$250 billion would be expected to flow into the Chinese market.

In May 2017, the PBC and Hong Kong Monetary Authority jointly announced plans to connect the Hong Kong and mainland bond markets in the 'Bond Connect'. Bond Connect signifies that China's interbank bond market is opening further, but is still subject to existing capital account management, qualification requirements for medium- and long-term institutional investors, requirements on the collection of investment and trading information, and other regulations. Bond Connect provides a new channel for foreign institutions to enter the market more efficiently. It can do so with the help of increased connectivity between domestic and foreign infrastructures in a mode that is well accepted in the international bond market. The experience of other countries shows that foreign investors can either enter the market by opening accounts in the domestic market, or by investing in the country's bond market through the connectivity of infrastructure. The first model places higher requirements on foreign investors who need to possess a comprehensive and in-depth understanding of a country's bond market regulatory system and market environment. The second model has become common practice globally. It enables foreign investors to access the global bond market conveniently via infrastructure connectivity and multilevel custody. Bond Connect operates according to the second model. By connecting the infrastructure of two bond markets, international investors can participate easily in the mainland bond market without changing their business practices, provided they comply with the regulations of the mainland market. Bond Connect will be implemented step by step with the overall planning and deployment of China's financial market liberalisation. To meet the current needs of international investors to invest in the mainland bond market, the current priority is 'Northbound' trading, which will be expanded to 'Southbound' trading in the future.

Compared with international practice, China's bond market still has a long way to go. At the end of 2016, overseas holdings of US Treasury bonds accounted for about 38.1 per cent of the total investment, and Japanese Government bonds for around 10.5 per cent. Foreign holdings in China's bond market accounted for less than 2 per cent and the lack of diversity in product structures is reflected in the high proportion of treasury and policy bank bonds. China's bond market has yet to be included in major international bond indices.

The stock market

China's stock market started to open in the early 1990s when the country's capital account was not yet open. To develop a channel for domestic companies to raise funds from overseas and facilitate foreign investors to invest in the domestic market, the State Council approved the Shanghai and Shenzhen stock exchanges to test issuing B-shares. In 1992, the B-share market was officially established. B-shares, also known as special RMB shares, are denominated in RMB and subscribed and traded in foreign currencies at the Shanghai and Shenzhen stock exchanges. Companies listed in the B-share market are all registered in China. Before February 2001, the B-share market was only open to foreign investors. It was then opened to domestic investors.

To further expand the channel for overseas financing and enhance the status of Chinese enterprises abroad, the Joint Working Group on Mainland–Hong Kong Securities Affairs was established in July 1992 with the approval of the State Council. Its main task was to provide consultations on state-owned enterprises going public in Hong Kong. After concluding the negotiations and completing the corresponding institutional arrangements, Tsingtao Brewery successfully issued H-shares and was listed on the Hong Kong Stock Exchange in July 1993, becoming China's first state-owned enterprise to list overseas. Since then, China has experienced a wave of mainland enterprises going public in the overseas market. In December 2012, the China Securities Regulatory Commission (CSRC) issued the 'Regulatory Guidelines in Relation to the Document Submission and Review Procedure for Overseas Stocks Issuance and Listing by Joint Stock Companies', which further strengthened supervision on domestic companies applying to issue shares and publicly list overseas.

With the gradual opening of the capital account, China introduced the QFII and Qualified Domestic Institutional Investor (QDII) schemes. As transitional arrangements, QFII and QDII are special ways to open the securities market orderly and prudently in countries and regions where the capital account is not yet fully opened. In December 2002, the CSRC and the PBC jointly issued the 'Interim Provisions on the Administration of the Domestic Securities Investments by Qualified Foreign Institutional Investors', and the first trade by QFII was made in July 2003. To open the capital account further, achieve a more balanced RMB exchange rate and give domestic investors the opportunity to participate in the global market, the QDII scheme was officially put into practice in July 2006, when the State Administration of Foreign Exchange (SAFE) approved a US$500 million quota to the Bank of Communications. In recent years, regulatory authorities have gradually eased qualification requirements and foreign exchange management and have raised investment quotas continuously. By the end of March 2017, SAFE had approved 280 QFIIs with an investment quota of US$90.3 billion and 132 QDIIs with an investment quota of US$90 billion.

In recent years, with the accelerated internationalisation of the RMB and liberalisation of the capital account, the depth and breadth of China's stock market opening has increased rapidly. In December 2011, the CSRC, PBC and SAFE jointly issued the 'Measures for Pilot Domestic Securities Investment Made by RQFII of Fund Management Companies and Securities Companies'. This allowed the Hong Kong subsidiaries of qualified fund and securities companies to conduct RQFII business. The early pilot quota was set at about CN¥20 billion. By the end of 2016, RQFII global pilot zones had been increased to 18, with a quota cap of CN¥1.5 trillion. By the end of March 2017, 182 RQFIIs had been approved and their investment quota reached CN¥541.4 billion. In November 2014, the PBC issued the 'Notice of the People's Bank of China on Matters Concerning the Overseas Securities Investment by RMB QDIIs', allowing qualified investors to invest in RMB-denominated products in overseas financial markets with their own or RMB funds raised onshore. Different from the approval system for QDII's quota, RMB Qualified Domestic Institutional Investor's (RQDII) quota is based on the amount of funds they actually raise.

To promote two-way opening and the sustainable development of the mainland and Hong Kong capital markets and increase the overall level of openness while integrating with the international market, the State Council approved the 'Shanghai–Hong Kong Stock Connect' in April 2014. After six months of preparation, the CSRC and Securities and Futures Commission of Hong Kong (SFC) issued a notice to officially launch the Shanghai–Hong Kong Stock Connect in November 2014. Further, to strengthen financial cooperation between the mainland and Hong Kong markets and to capture the regional advantages of the Shenzhen and Hong Kong stock exchanges, the State Council officially passed the 'Implementation Plan for Shenzhen-Hong Kong Stock Connect' in August 2016. In December 2016, the CSRC and SFC issued a notice to officially launch the Shenzhen–Hong Kong Stock Connect. Since then, qualified domestic individuals and institutional investors can trade stocks directly in the Hong Kong market, and foreign investors can trade stocks directly in the Shanghai and Shenzhen stock exchanges. Currently, both the Shanghai–Hong Kong Stock Connect and Shenzhen–Hong Kong Stock Connect are operating in a smooth and orderly manner, and cross-border capital inflows and outflows are approximately equal. China has achieved a cross-border trading system with proper regulation.

As the mainland and Hong Kong markets continue to deepen cooperation in financial products and services, in May 2015, the CSRC and the SFC announced plans for the joint development of the fund market. They signed a Memorandum of Understanding on Mutual Recognition of Funds (MRF) between the mainland and Hong Kong, and the CSRC simultaneously issued the corresponding 'Interim Provisions on the Administration of Recognized Hong Kong Funds'. In December 2015, the first seven mainland–Hong Kong MRFs were registered with the CSRC and SFC. In January 2017, the mainland–Hong Kong MRF service platform was launched. As new initiatives to open the capital market, the MRF, Shanghai–Hong Kong Stock Connect and Shenzhen–Hong Kong Stock Connect could complement each other, attract long-term capital and deepen capital market opening. By the end of February 2017, Hong Kong funds issued and sold on the mainland had generated a net outward remittance of CN¥7.3 billion, and mainland funds issued and sold in Hong Kong had a net inward remittance of CN¥97.45 million.

With increasing capital account convertibility, China's stock market is becoming more open, and its structure and mechanisms are becoming more diversified. In terms of the primary market, B-shares and H-shares have provided channels for domestic enterprises to raise capital overseas and for foreign investors to invest in domestic companies. Regarding the secondary market, schemes like QFII and RQFII have facilitated capital inflows, while QDII and RQDII schemes have facilitated capital outflows. Mechanisms like the MRF, Shanghai–Hong Kong Stock Connect and Shenzhen–Hong Kong Stock Connect have facilitated the two-way flow of capital, catering to the needs of various types of investors.

However, China's stock market is not as open as its international counterparts. At the end of 2014, the total market capitalisation of companies listed in London was £1.7 trillion, of which 54 per cent was held by overseas investors, a significant increase from 30.7 per cent in 1998. Foreign holdings reached 16 per cent in the US stock market, the world's largest stock market. Shares held by foreign investors in the South Korean stock market have remained at a constant level of over 30 per cent. Although foreign capital can now enter China's A-share market, the combined shares held by foreign investors through schemes such as QFII, RQFII, the Shanghai–Hong Kong Stock Connect and Shenzhen–Hong Stock Connect totalled less than 5 per cent in 2017.

The foreign exchange market

China's interbank foreign exchange market began to open in 2004, with the Bank of China (Hong Kong) and the Macau branch of the Bank of China entering the market first. With the introduction of cross-border RMB settlement business in 2009, the interbank foreign exchange market opened to foreign clearing banks with offshore RMB business. In 2015, the PBC allowed foreign central banks (monetary authorities), other official reserve management institutions, international financial organisations and sovereign wealth funds to participate in China's interbank foreign exchange market through agents, direct market access and other channels. They were allowed to conduct various types of foreign exchange trading, including spot, forwards, swaps and options, without quota restrictions. In January 2016, the PBC allowed internationally influential and regionally representative foreign banks involved in large-scale RMB selling and buying business to enter the interbank foreign exchange market. These banks could now participate in various types of foreign exchange trading, including spot, forwards, swaps and options. In February 2017, to help foreign investors participating in China's interbank bond market better manage their foreign exchange risk, qualified settlement agents were allowed to conduct foreign exchange derivatives business for foreign investors. They had to follow the principle of conducting trading based on real needs; however, foreign investors were only allowed to hedge foreign exchange risk exposure caused by investing in the interbank bond market with inward remittances. So far, China's interbank foreign exchange market has achieved varying degrees of openness for different types of investors. It now covers a full range of trading products and is more internationalised than ever. The entry of foreign investors has not only helped trading entities in the interbank foreign exchange market become more diverse, but is also an important force that enhances market liquidity and integration. By the end of May 2017, 66 foreign institutions were participating in China's interbank foreign exchange market, including 18 overseas RMB clearing banks, 19 foreign participating banks and 29 foreign central banks.

Apart from the introduction of different types of investors, China has also focused on developing direct and regional trading to further open the interbank foreign exchange market. To support RMB cross-border trade settlement, direct trading between the RMB, Malaysian ringgit and Russian ruble was launched in 2010, bypassing the USD cross rates. In 2014, RMB–Kazakhstani tenge interbank trading was launched. This bilateral direct exchange rate formation mechanism reduced trading costs and improved market transparency. To facilitate RMB internationalisation and implementation of the Belt and Road Initiative, in 2016, the interbank foreign exchange market launched direct trading mechanisms between the RMB and 11 currencies, including the United Arab Emirates dirham, South African rand and Saudi Arabian riyal. At present, 25 currency pairs exist in the interbank RMB foreign exchange market. This covers not only major international reserve currencies like the British pound and Japanese yen, but also the currencies of countries involved in the Belt and Road Initiative. In 2016, the trading value of these currencies amounted to nearly CN¥50 billion, twice the size of the previous year.

The interbank foreign exchange market is opening at a steady pace. It is cooperating with international mainstream institutions to construct a community of common interests and achieve gradual deployment in the global financial market. In 2015, following the Sino–US Economic and Strategic Dialogue and discussions between Chinese and German leaders, the China Foreign Exchange Trade System (CFETS) signed agreements with the Chicago Mercantile Exchange Group and the Deutsche Bank. These agreements clarified the shared objectives of achieving interconnectivity in financial infrastructure and financial products (such as exchange rate products) and of developing RMB-denominated offshore spot and derivative exchange rate products.

The interbank foreign exchange market is also actively promoting the internationalisation strategy, aiming at building a global service network, improving international financial service infrastructure and establishing a market with a higher degree of openness. Since January 2016, trading time in the market was extended to 23:30 Beijing time, covering European trading hours and part of US trading hours. This has facilitated the involvement of foreign investors. The service support time for all types of markets was also extended accordingly, enhancing the ability to serve global participants. Since 2015, the CFETS has released RMB exchange rate data based on the International Monetary Fund's (IMF) Special Data Dissemination Standard and RMB reference rates, providing pricing references to the IMF and other international organisations. In particular, since December 2015, the CFETS has compiled and issued the CFETS index, which has gained a widespread influence in the domestic and international markets.

The openness of China's foreign exchange market is much lower than that of advanced economies. For example, about 70 per cent of the trading volume in London's foreign exchange market—the world's largest—comes from foreign institutions. Seven out of the top 10 traders are non-British institutions, and the participants are very diversified and include multinational corporations, investment banks, mutual funds, hedge funds, foreign exchange funds and insurance companies. As for China, foreign investors participating in the interbank foreign exchange market only account for around 10 per cent of total investors, and their trading volume is less than 1 per cent. Further, the variety of foreign participants in the Chinese market is very limited, with banks being the only type of commercial institution participating.

Assessing the openness of China's financial market

Overall assessment

Although China's financial market is less open compared to other developed markets, its pace of opening has attracted worldwide attention.

In terms of the onshore market, China's stock, bond and foreign exchange markets have all opened up, but the degree of openness varies. The bond market has the highest degree of openness, followed by the stock market and then the foreign exchange market. In the primary market, although nonresidents cannot issue shares in the domestic stock market, various types of nonresidents (such as international development institutions, foreign non-financial enterprises, financial institutions and foreign governments) can issue bonds in the interbank market to raise funds. In the secondary market, the stock market introduced the QFII scheme in 2002, and then the RQFII scheme, Shanghai–Hong Kong Stock Connect and Shenzhen–Hong Kong Stock Connect. The interbank bond market has been fully opened to qualified foreign investors. The same entry standards are applied to both overseas and domestic institutions. Investors are not subject to any quota, but are subject to macroprudential management implemented by the PBC. Foreign investors participating in the interbank bond market can also participate in foreign exchange derivatives trading based on real demand.

The scale and geographic scope of the offshore market is expanding, and the products and participants in the offshore market are becoming increasingly diversified. Since 2010, the overseas offshore RMB market has developed steadily and rapidly with Hong Kong as the centre. A variety of RMB products have emerged, including credit, foreign exchange, bonds, funds and forwards. Trading activities are also very dynamic. The balance of RMB deposits in major offshore markets totalled about CN¥1.12 trillion at the end of 2016 (People's Bank of China, 2017). Fourteen locations, including New Zealand, London, Frankfurt, Seoul, Paris, Luxembourg, Doha, Toronto and Sydney, now have RMB clearing banks, covering Asia, Africa, America, Europe and Oceania. However, there is a spread between onshore and offshore RMB products and RMB exchange rates, which shows that capital control still exists and that financial market openness is still limited.

Regarding capital account convertibility, an increasing number of items under the capital account are gradually becoming convertible, and investment in the primary market is being liberalised at a steady pace. According to the classification of capital account transactions by the IMF's 'Annual Report on Exchange Arrangements and Exchange Restrictions' (seven major categories and 40 items), 37 items in China are fully convertible, basically convertible or partially convertible, accounting for 92.5 per cent of all items (see Chapter 5). Inconvertible items concentrate in the domestic primary financial market, which is still off-limits to nonresidents. Partially convertible items with more restrictions mostly relate to trading in the secondary market, which is not yet fully opened to the outside world.

Problems of the major financial submarkets in the process of reform and opening

Overall, the financial submarkets have different levels of openness, and China's financial market still has plenty of room to open to foreign investors. Market access for foreign investors and capital flows are still subject to many restrictions. Moreover, China's market system, market rules and regulations still need to gear up to international standards, which directly affects the participation of foreign investors in China's domestic market.

The bond market. Although the bond market is the most open market in China's financial system, the breadth and depth of its openness is still far from desirable. In particular, the rules and institutions of China's financial market differ significantly from those in the international market, and foreign issuers and investors often find it inconvenient to participate in the Chinese market. Some deep-rooted problems are hidden beneath the surface, damping the spirit of issuers and investors both at home and abroad.

First, China's accounting and auditing standards have caused much inconvenience for foreign issuers and have raised the cost of issuing bonds in the domestic market. According to existing regulations, the financial statements disclosed by overseas institutions should follow China's accounting standards, or equivalent standards as approved by the

Ministry of Finance. They should also be audited by accounting firms with securities and futures business qualifications in China, unless their country or region of origin has signed an agreement on the equivalence of public oversight over CPAs and auditing with China's Ministry of Finance. As Hong Kong is the only place that meets the aforementioned accounting and auditing requirements, foreign issuers from other countries or regions have to re-prepare their financial statements if they want to issue bonds in China. This has greatly constrained market development.

Second, China's rating industry lacks credibility. Therefore, it cannot meet the needs of international investors. China's rating services began late and are plagued by problems such as insufficient inspection on default rates, unrealistically high credit ratings and lack of ability to differentiate between bonds of varying quality. It is common practice for rating agencies to 'assign the rating based on the price' and to 'set the price based on the rating'. In China, enterprises with high ratings make up a significantly high proportion of the total. For example, enterprises with AA– or above constitute 97.13 per cent of all enterprises, much higher than the levels in the US, Japan and other countries. Conversely, enterprises with low ratings comprise a very small proportion of the total. As more enterprises end up with high ratings, enterprises with the same credit rating can have different risk levels, and it is difficult to distinguish the credit risks of enterprises with the same credit rating. When international investors allocate their assets globally, they develop their risk control system based on global rating standards. These are not shared by Chinese rating agencies. Concerns over China's rating quality prevent investment in China's bond market. In regard to bond issuers, as foreign issuers are usually experienced issuing entities, requiring them to hire unfamiliar Chinese rating agencies to undertake another rating would increase the cost of issuing bonds in China.

Third, market participants are subject to entry filing, one-level custody and centralised trading in China's bond market, which differs significantly from the international practice of investor suitability system, multilevel custody and decentralised trading. This situation has led to many technical obstacles for foreign investors investing in China. When the bond market opened up in 2005, foreign investors were required to comply with domestic regulations regarding market entry, trading, custody and settlement. Due to differences in the legal system, as well as in trading and settlement habits, foreign investors have encountered many technical problems, resulting in a slow pace of opening. In terms of filing for entry, foreign investors can only open an account after they submit a filing notice with the PBC's Shanghai headquarters via a settlement agent. In terms of transactions, the natural evolution of overseas markets has led to the formation of a hierarchal structure of dealer-to-dealer and dealer-to-customer trading. Within this structure, ordinary investors trade mainly through dealers. However, the Chinese market is flat and market makers have not developed enough, meaning that the ratio of one-on-one transactions among investors is especially high. In terms of settlement, the international market has adopted a multilevel custodian system, in line with the structure of trading. Investors need to open a nominal account in a custodian bank, and the custodian bank opens a custodial account in a central depository. With this model, the custodian bank can provide investors with a series of post-trade services, such as custody, clearing and settlement, and accounting reconciliation. In the one-level custodian system in China, investors must open an account directly at a central securities depository, and the settlement agents will provide trading and settlement services, but not all post-trade services. As the central depository deals directly with all investors, it is unable to cater to every investor's need. In terms of the settlement cycle, the overseas market is generally around T + 3, due to layered trading and multilevel custody, while the domestic market is generally T + 0, as the flattened structure enables higher settlement efficiency. This also creates unease among foreign investors.

Fourth, there is a limited variety of foreign exchange and derivative products related to bonds, which has slowed the opening process. Foreign institutions lack hedging instruments against exchange rate and interest rate risks when they invest in RMB bonds. Meanwhile, China's derivatives market is still at an early stage of development, with a small market size, homogenous participants and many technical obstacles for foreign investors. When foreign institutions invest in fixed income products, they usually develop a systematic trading strategy (called FICC) that integrates fixed income products, commodities and currency products. However, in China, different products have different levels of openness to foreign investors. The bond market opened up ahead of the derivatives market and the foreign exchange market. In this case, foreign investors cannot use derivatives and foreign exchange instruments effectively to develop their investment strategies.

Fifth, international cooperation on financial market infrastructure can be improved further. Foreign institutions involved in the domestic market have to deal with very complex technical details due to the lack of unified and transparent rules and institutions. The adoption of a case-by-case model can destabilise foreign investor expectations. Further, China's financial market infrastructure cannot fully meet the needs of foreign institutions. International electronic trading platforms are very developed after years of market competition, through which foreign investors can monitor market movements, place orders and conduct transactions. However, China's trading terminals lag behind in terms of language service and convenience. The major international bond markets have formed a multidimensional network with multilevel custody arrangements, enabling investors to access the global market easily, while providing them with services such as margin trading, data and research. In the process of opening, China must integrate further with international infrastructure.

The stock market. Securities investment has adopted a channelled approach to opening and is yet to open up completely. Although A-shares have been included in MSCI's EMs review list since 2014, it was not until June 2017 that MSCI announced that it would incorporate A-shares into the MSCI EM Index starting in June 2018 (MSCI, 2017). The A-shares will only account for 0.7 per cent of the index, far below China's proportion of economic size, trade volume and stock capitalisation globally (14 per cent, 14 per cent and 15 per cent respectively).

In terms of investment, although the stock market introduced QFII as early as 2002 and gradually extended to RQFII, the Shanghai–Hong Kong Stock Connect, the Shenzhen–Hong Kong Stock Connect and other mechanisms, foreign investors entering China's stock market are still subject to many restrictions. The QFII scheme imposes a quota for monthly capital redemption, and pre-approval by exchanges is required for financial products related to A-shares. Moreover, the QFII and RQFII schemes do not share unified standards for market access. The requirements for entry are high, and the scope of investors qualified to apply is limited. Long-term foreign capital that entered the domestic market through the QFII or RQFII schemes is restricted in areas such as quotas and liquidity. Such restrictions may reduce the enthusiasm of long-term investors and affect the abilities of such schemes to improve investor structure, promote long-term investment and enhance the governance of listed companies.

Individual investors abroad can only invest in underlying stocks listed in the Shanghai and Shenzhen exchanges via the Shanghai–Hong Kong Stock Connect and Shenzhen–Hong Kong Stock Connect.

In terms of financing, the development of bi-directional cross-border financing is not balanced. Foreign enterprises are not yet allowed to engage in equity financing in the A-share market. Although domestic enterprises can now raise money overseas through the H-share market without much obstruction, the approval system for overseas refinancing is not capable of seamless convergence with fast tracks such as lightning placement. The B-share market has basically lost its financing capability for now.

The foreign exchange market. The principle of 'trading on real needs' has somewhat limited further opening of the foreign exchange market. At present, the domestic foreign exchange market is a regulated market based on the principle of servicing real demand, while the international market has no such principle. Data analysis shows that less than 10 per cent of trading volume in the international market is driven by real trade. Based on the principle of real needs, the interbank foreign exchange market has been prudent when engaging foreign investors. Although foreign central banks and clearing banks can now enter the market, investment banks, commercial banks, insurance institutions, pension funds, hedge funds and large enterprises are still not allowed. This problem is also reflected in the structure of domestic investors, which is dominated by commercial banks, with non-bank financial institutions and non-financial enterprises accounting for a relatively small proportion. The limited type and number of market participants leads to similar trading behaviour. It also homogenises market demands and lowers the demand for foreign exchange derivatives. Further, the volume of trading in the domestic market lags far behind the international level.

To facilitate initiatives such as the Belt and Road Initiative launched in recent years, the CFETS introduced dozens of new currency pairs in a short period. However, the participants have not been very active, leading to a low trading volume and liquidity shortage. The trading between the RMB and non-US currencies accounted for a market share of less than 5 per cent. Small currencies that saw active trading was concentrated in China's neighbouring countries or developed economies, while the remaining small currencies remained quiet. Regional currencies, such as the Kazakhstani tenge, were basically not traded at all.

Financial infrastructure. The organisation of China's financial infrastructure is markedly different from that of the international market. The international market usually uses a multiple-level custodian system and a more developed market maker system. China's financial infrastructure is replete with Chinese characteristics and tailored to China's national condition, such as the fact that China's market is still at an early developmental stage and the governance of companies remains imperfect. Because of this, China's financial infrastructure is relatively centralised. To address the imperfections of companies' governance structures and the risk of clients' securities being misappropriated, as well as enhance information monitoring, improve transparency and provide a normalised trading platform, the interbank bond market has constructed a unified electronic trading platform for bond custody and settlement, implemented real-name centralised custody and one-on-one bidding. Therefore, China's centralised infrastructure is well adapted to the country's economic and financial environment. Additionally, this system showed its merits during the 2008 global financial crisis. Even the regulatory reforms introduced after the crisis were directed towards infrastructure centralisation.

However, in the process of opening, these Chinese characteristics have not been very compatible with international conventions and technical operation, especially in areas such as opening accounts, custody, transactions and settlements. This inconsistency has negatively affected investment from foreign institutions in the domestic market. Since China's bond market started to open up in 2005, only 480 foreign investors have invested in the market and their holdings amount to CN¥800 billion, only 1.2 per cent of the total. This is not only far lower than the proportion of 30–40 per cent in developed European countries and the US, but is also lower than the 10 per cent in Russia, Malaysia and other emerging economies.

Part 3: Promoting a higher level of openness of the financial market

At present and in the near future, further development of the financial market through opening is necessary for China to enhance its international competitiveness. Only an open financial market can possess real scope and depth. Such a financial system can form price signals that are truly representative and effective, attract more capital and investors, and support development of the real economy. China has now consolidated its position as the world's second-largest economy after the US and its economy has entered a 'new normal' phase. For now, China's market reforms on interest rates and exchange rates have entered the final stage, capital account liberalisation has basically been achieved, and the international status of the RMB has been further improved with its inclusion in the SDR basket. However, it should also be noted that China does not have the ability to completely reshape the rules of the global financial system and still needs to conform to international standards. In the process of opening, China should seek inclusion and cooperation, rather than putting its own needs first. By actively adapting to international rules and gradually integrating into the international financial order, China can establish a healthy pattern that combines domestic reform with opening-up to the outside world.

Solve the structural problems of China's financial market in the process of reform and opening and uncover market potential

Since its reform and opening up, China has established a financial market and institutional system that aligns with the socialist market economy and that has made important contributions to the sustained and healthy development of the Chinese economy. However, China's financial market has only played a limited role in promoting capital formation, optimising resource allocation and enabling economic transition and structural adjustment. Compared to advanced market economies, China's financial market has prominent structural problems. First, the proportion of direct financing is too small. Second, shadow banking is putting pressure on the bond market, a situation similar to 'bad' money driving out 'good' money. Third, the structure of the bond market needs to be improved. Fourth, equity financing is underdeveloped, and retail investors are its main participants. Fifth, the financial derivatives market remains underdeveloped. In the future, China should persist in respecting and adapting to international market rules and practices. The reforms of the domestic financial market should be deepened on the basis of opening. Further, the financial regulatory framework should be improved to achieve coordinated development between direct financing and indirect financing, between equity financing and debt financing, and between basic products and derivatives products. Only in this way can China establish an advanced financial market system that matches its economic status and supports sustainable development of the real economy. This financial market system needs to be all encompassing, properly structured, efficient, stable, inclusive and competitive.

Open the financial market through overall coordination and improve the framework of macroprudential management

China should open its financial market in a methodical way, following a suitable roadmap and sensible timetable. First, there must be an overall plan and the process can be adjusted as required. Factors that should be considered include domestic and international economic and financial situations, China's foreign debt serving capacity and balance of payments position, the real economy's demands on financial services, and the impact of two-way financial opening. Cross-border regulatory capacity should be strengthened. A roadmap and a timetable for two-way opening should be prepared. Second, domestic financial development and opening policy should be better coordinated. For now, China should aim for a higher level of openness based on respecting international market rules and practices. It should simultaneously open the foreign exchange derivatives markets in a coordinated manner. In the process of opening, authorities should focus on integrating domestic rules with international standards and avoid overemphasising Chinese characteristics.

China should improve the macroprudential management framework and control the risk of cross-border capital flows. The macroprudential policy framework for foreign debt and cross-border capital flows should be improved to strengthen the risk management capacity under enhanced convertibility. The match of currency types and maturity of assets and liabilities should be considered, the size of foreign debt should be subject to adjustment and the structure of foreign debt should be optimised. It is important to monitor foreign debt and keep risks under control. It is also necessary to curb short-term speculative capital shocks through market-based measures and strengthen regular monitoring and risk warnings about foreign investor behaviour and large amounts of abnormal cross-border flows. Alongside these measures, China should also urge participants to perform obligations such as monitoring and information reporting to prevent illegal transactions and control the risk of abnormal cross-border capital flows.

Open the credit rating market in an orderly manner

First, China should allow the entry of international rating agencies into the domestic bond market for credit rating business. Detailed requirements should be clarified in respect of international rating agencies. Unified administrative rules for rating agencies should be established and improved, and a unified registration and supervision system should be established. As long as ratings are released 'for regulatory purposes', an agency should be subject to regulation, regardless of whether it is domestic or foreign. Meanwhile, an investor- and market-oriented evaluation mechanism should be established, and a mandatory exit mechanism introduced. Additionally, as rating agencies have entered the market in different ways, they should also be regulated differently. International rating agencies that have engaged in rating business by building a commercial presence in China should be treated in the same way as domestic agencies. International rating agencies that provide cross-border rating business services must learn from international experience and coordinate with regulators in their country of origin. It is necessary to refrain from overregulation and avoid regulatory conflicts, as rating agencies may feel uneasy and confused and their business may decline. It is also important to avoid oversights and loopholes so that rating agencies will have no opportunity to conduct arbitrage activities. In the early stage of opening the rating industry, it is viable to only consider supervising the business of international rating agencies conducted in China. Possible regulatory measures could be inquiries and access to their working papers. Ultimately, it is necessary to strengthen cooperation with international regulators and achieve coordinated supervision by signing cooperation agreements.

Second, China should take advantage of international rating agencies and gradually liberalise the domestic bond rating business. The bond market should reduce its reliance on credit rating and stop treating ratings as a prerequisite for issuing bonds. Historically, China has been overprotective of the rating industry and required all bonds be rated before being issued. This was an administrative intervention that helped rating agencies gain dominance. As China's bond default rate is very low, it is almost impossible to effectively verify the accuracy of ratings. This has prompted rating agencies to prioritise market share over their own credibility. Once mandatory rating requirements for bond issuance are lifted, rating agencies will focus more on their credibility to gain recognition from investors, and international rating agencies will play a bigger role in improving the quality of domestic ratings. It is also vital to coordinate the global rating system with the local rating system and to open the domestic rating industry methodically. International rating agencies use global rating standards. These specify that the ratings of Chinese enterprises cannot surpass China's sovereign rating (A+ or AA–). However, the highest rating given by domestic rating agencies to domestic enterprises is AAA. In this context, the same issuer may have very different ratings at home and abroad. In the early stages of opening, attention should be paid to the coordination between the two systems to avoid pricing confusion. In this sense, it is necessary to gradually liberalise the rating business. At an early stage of the process, foreign institutions planning to issue Panda bonds or domestic institutions that have raised funds overseas can be rated by international rating agencies.

Implement multilevel management to offer foreign issuers greater flexibility in terms of auditing and accounting

First, China should allow foreign issuers to choose their own accounting standards to prepare financial reports. Most participants in China's bond market, especially in the interbank bond market, are qualified institutional investors with the capacity to identify risks and make judgements about the financial statements of foreign institutions. Foreign institutions that issue bonds to qualified institutional investors can be allowed to prepare their financial statements based on accounting standards that align with China's accounting standards for business enterprises or are recognised by China's Ministry of Finance. However, they should note the differences between their own and China's accounting standards. Regarding the statement of important differences, foreign government agencies (including sovereign governments and local governments), international development institutions and other foreign institutions with high credit worthiness and international influence only need to disclose the major differences. Financial institutions, non-financial enterprises and other foreign commercial institutions must make adjustments on the differences between their accounting and China's standards while disclosing reconciliation statements. Moreover, in the case of foreign institutions issuing bonds to certain qualified institutional investors, considering the limited number of investors involved and their familiarity with the issuers, the two sides may be allowed to negotiate the type of accounting standards between themselves.

Second, China should allow qualified foreign accounting firms to provide auditing services to foreign institutions issuing bonds to qualified institutional investors in China. International practice shows that when Chinese institutions issue bonds to qualified investors in the US market, they often refer to the audit opinions issued by Chinese accounting firms. US regulators had never asked to sign a cooperative agreement on audit regulation with China. At present, the legal framework for the capital market's opening is still under development. Signing cooperative agreements on audit regulation with countries where the overseas accounting firms are based can help China improve its regulation and facilitate cross-border recourse efforts in relation to bond default. For now, the Hong Kong Special Administrative Region is the only jurisdiction that has signed such a cooperative agreement with China. This lack of agreements has increased the cost and dampened the spirits of foreign institutions issuing bonds in China. It is proposed that China accelerates the process of reaching agreements with other countries and regions on audit regulation, while simultaneously allowing accounting firms to proceed with their audit service after filing with the Ministry of Finance. No filing procedure is required for accounting firms based in Hong Kong; they only need to follow the guidance of the signed cooperation agreement.

Finally, China should issue a set of unified administrative rules for foreign institutions participating in China's bond market as soon as possible. It is important to clarify the requirements, including accounting and auditing policies, for foreign government agencies, international development institutions and foreign business institutions that plan to issue bonds in China. Such requirements should be more transparent and standardised.

Clarify tax codes for foreign investors planning to enter China's bond market

First, China's finance and taxation departments should immediately clarify the tax details for foreign investment in China's bond market so that more foreign institutions will be willing to invest in China. On issues such as whether and how to levy corporate income tax and value-added tax, China could learn from international practice and develop highly operable, clear and specified tax policies. The requirements concerning withholding tax should be made clear for registration and custody agencies in the interbank market.

Second, China should clarify regulations concerning preferential tax policies in international agreements and tax treaties. For example, the suitable objects, application methods and procedures should be specified clearly.

Third, regarding foreign investors' interest income and the spread income from investing in Panda bonds in China's interbank bond market, it is necessary to exempt these types of income from corporate income tax and value-added tax to avoid double taxation and enhance transparency.

Additionally, the tax department should promote the publicity of tax policy, creating a fairer and more transparent policy environment for foreign institutions investing in China's interbank market.

Construction of financial infrastructure should consider China's actual conditions and international practice

A practical approach for adapting to the different habits and characteristics of investors would be to adopt a centralised custody system for domestic investors and a multilevel custody system for foreign investors. The former suits China's actual conditions, while the latter aligns with international practice.

The Bond Connect launched in July 2017 is characterised by multilevel custody, nominal holdings, centralised trading and 'penetration supervision'. Such institutional arrangements are a reasonable and effective way to further open the bond market and attract international investors. From a macro perspective, the Bond Connect essentially helps foreign investors to conveniently and effectively allocate RMB bond assets through internationally accepted arrangements that they can understand and accept. Bond Connect can lead to smoother capital inflows and debt outflows. It can also help with China's balance of international payments, support economic and financial deleveraging, reduce financing costs and consolidate financial security. From a micro perspective, Bond Connect, which introduced multilevel custody into Chinese banks, offers a historic opportunity for Chinese financial institutions to participate in international custody business. This can enhance their global competitiveness and ability to safeguard financial security.

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